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TAX COMPLIANCE TRENDS: REVIEW AND OUTLOOK

HIGHLIGHTS

1. Initial TEFRA proposals to improve taxpayer compliance would have imposed extremely costly and unreasonable tasks on financial intermediaries. As it is, the financial services industry is committing considerable resources to comply with the new reporting requirements. Given the continued pressure to reduce projected deficits, financial intermediaries may well face additional burdens in the future.

2. The estimated tax gap for 1981 is $81.5 billion for the legal sector, with $52.2 billion attributed to unreported individual income. The largest single problem for the IRS is individuals who do not accurately report their income.

3. The figures quoted by IRS and Treasury in 1982 constituted ample fuel to send Congress on a mission to close the taxpayer compliance gap. However, the most recent years for which actual measures of noncompliance are available are 1976 for filers and 1977 for nonfilers. Thus, the noncompliance figures cited for 1979 and 1981 which were used to initiate specific legislation are, at best, only rough estimates.

4. The underlying point for all tax compliance proposals is, of course, the yield ultimately produced. For example, gross proceeds reporting is estimated at generating additional revenues of $22 million in 1983 and $120 million in 1984. Given the substantial costs to the private sector and a triple digit deficit, it is doubtful that such regulations are cost effective approaches to reducing the deficit.

5. While the system of cross checks and balances may become increasingly elaborate, the question remains: will the IRS have sufficient resources to make use of the information received and to follow up on the noncompliant taxpayer. There are probably insufficient resources to adequately use the plethora of information that will be received under TEFRA.

Introduction

The Economic Recovery Tax Act of 1981 (ERTA) represented the largest tax cut in history--almost $750 billion over a six-year period. The feeling of elation over the 1981 tax cuts disappeared early in 1982 as Congress and the business community became increasingly concerned with an escalating Federal budget deficit. However, Congress and the President were stalemated as to how to redress the problem. There was both a reluctance to make additional spending cuts and an unwillingness to pass a general tax increase or tamper with the third-year tax cut. In the search for measures to dwarf the escalating deficit, IRS/Treasury studies and recommendations concerning growing taxpayer noncompliance gained in significance and political appeal. Thus, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the largest revenue-raising bill in history, was designed to raise an additional $98.3 billion in revenues over a three year period. The individual taxpayer would feel the bill's effect mainly through improved tax collection and enforcement efforts.

Initial proposals to improve taxpayer compliance would have imposed extremely costly and unreasonable tasks on financial intermediaries. As it is, the financial services industry is committing considerable resources, both in actual outlays and manpower, to comply with the new reporting requirements. This Trends issue will review the taxpayer compliance problem, the development of TEFRA, and prospects for further compliance-tightening initiatives. Much of the discussion represents summaries of government work in this area. Government will be under pressure to reduce the deficit for some time to come and closing the estimated taxpayer compliance gap seems to be the path of least resistance. Financial intermediaries are now feeling the brunt of recent increased reporting requirements and may well face additional initiatives in the near future. The following aptly sums up sentiment by some policymakers who favor "limited new burdens on highly automated third party payors":

> This allocation of the burden is proper not only because payors can most efficiently carry the new reporting (or withholding) responsibility but also because there is no alternative. Compliance levels would be unsatisfactory absent such an allocation.*

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* John Andre LeDuc, "An Evaluation of Recent Taxpayer Compliance Legislation and Future Options," Tax Notes, 7/11/83.

The Compliance Problem*

The American tax system is based on the principle of voluntary assessment. Through the tax system, government garners the revenues to finance 90% of its activities. It is argued that a voluntary compliance system is the most efficient and effective approach to collecting taxes and is likely to promote the highest degree of public acceptance of this basically unpopular government function. In 1982, individuals voluntarily filed about 96 million returns and paid $352.6 billion in income taxes. Total revenue collections from all sources amounted to $632.2 billion. Based on 1981 data, IRS operating costs totaled $2.5 billion, resulting in an average cost of 41 cents for every $100 collected.

Despite the collection of what seems like vast sums, IRS statistics show that the percentage of income voluntarily reported by individuals has steadily declined. According to IRS estimates, the legal sector tax gap has grown from $28.8 billion in 1973 to $81.5 billion (see Table I). Voluntary taxes paid by all sectors may have fallen short of the 1981 tax bill by as much as $90.5 billion, with $75.3 billion attributed to individuals, $6.2 billion attributed to corporations, and $9.0 billion attributed to illegal source income. Of the $75.3 billion in estimated 1981 individual taxes lost, unreported income accounted for $52.2 billion. The largest single problem for the IRS is individuals who do not "accurately" report their income. Failing to report income accounts for more than two times the lost tax revenue from the combined results of overstating tax deductions and other "offsets" to income, failing to file returns, and not paying assessed taxes.

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* Much of this section is a summary of Further Research Into Noncompliance Is Needed to Reduce Growing Tax Losses, A Report to The Congress by the Comptroller General, Government Accounting Office, 7/23/83; and Income Tax Compliance Research, Treasury/IRS, Office of the Assistant Commissioner, Research Division, 7/83.

TABLE I

INCOME TAX GAP, 1973-81
($ Billions)

	1973	1976	1979	1981
Legal sector tax gap, total	$28.8	$39.2	$62.3	$81.5
Corporation tax gap, total	3.5	4.6	6.4	6.2
Individual tax gap, total	25.3	34.6	55.9	75.3
Individual income tax liability reporting gap, total	23.8	32.2	50.6	68.5
Nonfilers' income tax liability (Net of prepayments and credits)	0.9	1.4	2.0	2.9
Filers' income tax liability:	22.9	30.8	48.6	65.6
Unreported income	17.3	24.2	38.4	52.2
Overstated business expenses	2.1	3.4	4.7	6.3
Overstated personal deductions[1]	3.4	3.0	5.0	6.6
Net math errors	0.1	0.2	0.5	0.5
Individual income tax remittance gap, total	1.5	2.4	5.3	6.8
Employer underdeposit of withholding[2]	1.1	0.9	1.8	2.4
Individual balance due after remittance	0.4	1.5	3.5	4.4
Illegal sector tax gap (partial)[3]	2.1	3.4	6.3	9.0
	(0.8)	(1.3)	(2.2)	(3.2)

Source: Income Tax Compliance Research, IRS, 7/83

[1] Includes itemized deductions, personal exemptions, and statutory adjustments.

[2] Also includes a small amount for underreported withholding by employees and a small negative amount for underclaimed withholding by individuals.

[3] Includes income from illegal drugs, illegal gambling, and prostitution only. Figures in parenthesis are standard errors.

Regarding unreported wages, a Harris Poll conducted for *Business Week* indicated that as many as 30% of all American households have some member working in the underground economy.* Even these results have to be taken with "a grain of salt," as most individuals would be reluctant to admit that they are hiding income. The reasons for the decline in voluntary compliance are elusive, running the gamut from total ignorance to willful evasion. A recent article attempted to sum up the "psychology" of the taxpayer. The individual's perception of the tax code is based on: 1. widespread awareness that others are cheating; 2. a "gimmick" or exception riddled tax code that fails to convince the taxpayer that paying taxes is an intelligent and decent thing to do; and 3. publicity of federal waste or mismanagement of tax revenues.*

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* "Answers that unveil the underground economy," *Business Week*, 10/11/82.

The IRS has not been any more successful in identifying what makes people comply with tax laws than independent researchers. The IRS believes that examination of tax returns, the largest of its nine compliance programs, yields a significant positive effect on taxpayer compliance. In 1982, IRS examined 1.7 million tax returns, with coverage of income, estate, and gift tax returns at 1.6% of such returns filed. Based on the 1982 examinations, additional assessments and penalties totaling $11.7 billion were recommended, $3 billion of which related to individual tax returns. In addition, IRS service center contacts were made for about 700,000 returns which resulted in proposed tax assessments totaling about $268 million. IRS believes that the compliance for a taxpayer class correlates positively with the examination coverage for that class; and that given certain high rates of examination coverage, voluntary compliance will over time approach 100%.

Nevertheless, IRS reports that normal audit procedures are unsuccessful in detecting unreported income. IRS estimates indicate that even the most intensive examinations detect only about 25% of the income not reported by those taxpayers audited. To carry this fact one step further, the IRS cannot rely heavily on its normal, less intensive audits to detect unreported income.

IRS also believes that its information returns program (IRP), wherein third-party documents are matched with tax returns, significantly affects voluntary compliance. However, in the past, only a relatively small share of compliance resources was allocated to this program. For example, 5% of total compliance resources was allocated to IRP in 1981. In that year, IRS received 664 million information documents, 435 million of which were from business and organizations reporting interest, dividends and other payments. About 80% of these documents were compared with the related tax returns. Document matching resulted in additional tax assessments totaling about $500 million for cases generated in prior years and completed in fiscal year 1981.

Estimates of Unreported Income

In July 1983, IRS released a report, Income Tax Compliance Research, which it believes is its most comprehensive attempt to date to estimate noncompliance in the U.S. While the figures provided in this report were apparently quoted in 1982 as TEFRA was being structured, neither the report nor methodology were made available for public comment and scrutiny at that time. For the individual sector, the estimates of underreported income and overstated items are based on data from IRS's Taxpayer Compliance Measurement Program (TCMP). The most recent year for which actual measures of noncompliance from this source could be used is 1976. For nonfilers, the most recent data on actual unreported income is 1977. Thus, the noncompliance figures for 1979 and 1981 are estimates, and nothing more.

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* Washington Magazine, 4/82.

According to the data in Table II, unreported legal source income escalated from $93.9 billion in 1973 to $249.7 billion in 1981. Unreported wages and salaries rose at a 184% pace, while the majority of other categories increased by somewhat less. The exception is investment income which was estimated as rising even faster than wages and salaries.

TABLE II

Unreported Legal-Source Income of
Individual Filers & Nonfilers, 1973-81
($ Billions)

	1973	1976	1979	1981
Wages & Salaries	$33.3	$ 46.3	$ 71.1	$ 94.6
Dividends	1.9	3.6	5.5	8.7
Interest	4.4	6.8	11.5	20.5
Capital Gains	5.0	9.9	16.3	17.7
Nonfarm Proprietor, Partnership & Small Business Income	23.9	32.6	47.2	58.4
Farm Proprietor Income	5.7	4.5	7.8	9.5
Informal Supplier Income	10.3	12.7	17.0	17.1
Pensions & Annuities	3.1	4.1	6.3	8.8
State Income Tax Refunds, Alimony, & Other	4.0	6.8	6.3	7.1
Other 1/	2.1	4.2	5.5	7.2
Total	$93.9	$131.5	$194.5	$249.7

Source: Income Tax Compliance Research, IRS, 7/83.

Note: Total may not add due to rounding.

1/ SIA residual category.

Reviewing components as a percentage of the estimated total, unreported wages and salaries by and large account for the lion's share of noncompliance, $94.6 billion or 37.9%, followed by nonfarm proprietor, partnerships, and business income at $58.4 billion or 23.4%. While investment income has moved up in the rankings of percentage share of unreported income, it is still dwarfed by unreported salaries and business income. As a percentage of 1981's total unreported income, interest represented 8%; capital gains, 7%; and dividends, 3.5%.

Given that the period 1973-81 was subject to bouts of double digit inflation, IRS believes that the underlying tendencies can be overshadowed if noncompliance is measured only in current-dollar terms. Therefore, to determine the "hidden trends" in the raw data, the IRS recasts the measure into voluntary reporting percentages (VRPs). VRPs relate sums voluntarily reported to sums that should have been reported based on IRS estimates.

Overall voluntary reporting of all income slipped from 91.2% in 1973 to 89.3% in 1981, or at a rate of about two-tenths of a percentage point each year over this period (see Table III). The most serious decline in compliance was reportedly in capital gains income, for which the 1973 compliance rate was already among the lowest according to IRS estimates. The estimated voluntary reporting percentage for capital gains income declined from 75.7% in 1973 to 59.4% in 1981, an average decline of slightly more than 2 percentage points per year. While the percentage of interest voluntarily reported changed little over the 1973-81 period, dividends reported took a sharp fall from 90.7% to 83.7%. Nevertheless, estimated voluntary compliance for interest and dividends is still relatively high.

TABLE III

Estimated Reporting Percentages for Individual Filers & Nonfilers, 1973-81

	1973	1976	1979	1981
Wages & Salaries	95.3%	94.9%	94.4%	93.9%
Dividends	90.7	87.1	85.7	83.7
Interest	87.6	88.1	86.3	86.3
Capital Gains	75.7	64.3	63.4	59.4
Nonfarm Proprietor, Partnership, & Small Business Income	84.0	82.2	80.7	78.7
Farm Proprietor Income	88.6	92.6	89.5	88.3
Informal Supplier Income	20.7	20.7	20.7	20.7
Pensions & Annuities	83.5	86.9	86.7	86.9
State Income Tax Refunds, Alimony & Other	66.0	55.2	62.3	62.0
Other1/	83.7	79.6	78.4	77.7
Total	91.2%	90.4%	89.8%	89.3%

Source: Income Tax Compliance Research, IRS, 7/83

1/ SIA derived average

Focusing only on 1981, Table IV depicts the actual with the projected income reported. The IRS relates the high percentages of voluntarily reported income to the effectiveness of withholding in the case of wage income and to information reporting in the case of interest, dividends, estate and trust income, and pensions and annuities. It is not surprising, therefore, that the mainstays of TEFRA's compliance measures were withholding and increased information reporting. What is surprising was the attempt to impose withholding on interest and dividends where compliance is high, as even the IRS concedes.

TABLE IV

Individual Income Tax Net Income Reporting Compliance, by Type of Income, 1981
($ Millions)

Type of Income	Reported on Tax Returns	Should Have Been Reported	Voluntary Reporting Percentage
Wages & Salaries	$ 1,455,154	$ 1,549,735	93.9%
Dividends	44,945	53,692	83.7
Interest	129,112	149,591	86.3
Capital gains	25,934	43,661	59.4
Nonfarm proprietor income (except informal supplier income)1/	53,580	106,522	50.3
Farm proprietor income1/	-2,051	11,095	--2/
Partnership and small business corporation income1/	14,859	31,604	47.0
Informal supplier income1/	4,465	21,545	20.7
Pensions and annuities	58,458	67,257	86.9
Rents1/	2,564	6,890	37.2
Royalties	4,361	7,131	61.2
Estate and trust income1/	3,869	5,215	74.2
State income tax refunds, alimony, and other income	11,700	18,866	62.0
Total income	$1,806,950 3/	$2,072,804 3/	87.2%

Source: Income Tax Compliance Research, IRS, 7/83

1/ Business incomes were estimated on a net basis, to make the voluntary reporting percentages (VRP's) for these sources of income reflect a second dimension of noncompliance in the possibility of overstated expenses.

2/ The VRP cannot be calculated since the reported amount is a negative figure.

3/ The difference between these two figures is $265,854 million, which equals the sum of total unreported income of $249,675 million and overstated business expenses of $16,179 million.

To derive estimates of underreported income, the IRS relied on its TCM program, which is conducted every three years, and its Information Returns Program. Based on the latest TCMP-IRP study, 1976, the ratio of total unreported IRP-covered income to the amount discovered by TCMP for income items for which IRS documents were available was conservatively estimated at 3.5 to 1. Thus, the ratio was applied to income items not covered by information reporting, such as capital gains. The 3.5 multiplier, however, is based on a small subsample of the TCMP sample population and actual contact was made with fewer than 1,000 taxpayers.

The starting point for the unreported capital gains estimate is the 1976 "misclassified or unreported" capital gains figure of $3,361 million from TCMP. Allowing for 25% human error, 75% of the $3.4 billion was subsequently multiplied by 3.5. Projections for 1979 and 1981 were made by applying regression analysis to data from the Statistics of Income in 1980 and estimates for 1981 to determine what TCMP would have yielded. Projections of unreported income were first made for total income, and projections for particular types of unreported income were forced to this projected total by proportional adjustments. All in all, many assumptions were required on which early legislative initiatives requiring the reporting of capital gains were based.

Finally, in order to estimate the tax gap for individual filers, the estimates of understated taxable income is multiplied by an average marginal tax rate, which is derived via the Treasury's tax model. Table V displays select components of the estimated $52.2 billion tax gap generated by filers in 1981.

TABLE V

Unreported Income and Related Tax Gap, by Type of Income, for Filers, 1981

($ Millions)

Type of Income	Unreported Income	Marginal Tax Rate in Percent	Tax Gap[1]
Wages and salaries	$18,881	30.8%	$6,283
Dividends	6,596	42.6	3,027
Interest	12,120	32.8	4,286
Capital gains	15,241	43.4	7,136
Nonfarm proprietor income (except informal supplier income)	33,615	39.6	14,353
Farm proprietor income	8,499	27.3	2,504
Partnership and small business corporation income	10,786	44.7	5,195
Informal supplier income	13,848	30.8	4,608
Pensions and annuities	4,131	26.6	1,184
Other income[2]	10,124	----	3,622
Total income	$133,840	39.0%	$52,198

Source: Income Tax Compliance Research, IRS, 7/83

1/ Components have been forced to the total by proportional adjustment.

2/ SIA residual category.

The Development of TEFRA

Clearly, the estimated figures quoted by IRS and Treasury in early 1982 constituted ample fuel to send Congress on a mission to close the tax gap, a mission which would mitigate the need to raise taxes. Indeed, all policymakers jumped on the bandwagon. In his State of the Union Address on January 26, President Reagan introduced a 5% domestic withholding tax on dividends and interest. Shortly thereafter, two bills were introduced, HR 5829 and S 2198, which presented an alternative to withholding. These bills focused on another area of noncompliance -- capital gains. While the possibility of the imposition of a withholding tax unleashed considerable public protest, the brokerage community was virtually horrified by the proposal to report capital gains. When introducing S 2198, Senator Robert Dole stated that "low-cost information reporting on capital gains in commodities and securities transactions would be required from the highly computerized securities and commodities brokerage industry."

Although the well-publicized paper crisis of the late 1960's had sent the securities industry scurrying to computerize, the sophisticated technology necessary to report capital gains and losses was simply nonexistent. In May, HR 6300 was introduced which replaced capital gains reporting with gross proceeds reporting, but kept the language allowing the Secretary the authority to require reporting of gains and losses. All of these bills substantially expanded the types of securities subject to information reporting and increased the penalties for various forms of noncompliance.

While the documentation for the noncompliance figures quoted by government has been recently released, none of this research work was available in 1982. This was particularly aggravating in the area of capital gains. The recently released study does show a 59% estimate of compliance for capital gains. However, this estimate includes gains in real estate, collectibles and other tangibles. Moreover, during the 1982 discussions, an informal government estimate placed compliance in capital gains in securities transactions at about 80%. A far cry from 59%! Nevertheless, although there is an obvious need to extend gross proceeds reporting to all assets giving rise to capital gains and losses, early on it became evident that this requirement would apply only to commodity and securities transactions -- the areas of highest compliance.

Despite credible and well-supported public testimony by SIA and representatives of other financial intermediaries plus countless informal meetings with government staff, TEFRA contained many provisions that placed a heavy resource burden on the private sector. The expanded interest reporting, broker information returns and withholding provisions of TEFRA, where workable, would cost millions of dollars. In some cases, the provisions were not only set in unrealistic time frames, but were clearly unworkable given current industry operational procedures and systems capabilities. Nevertheless, at least capital gains reporting would not be required.

Withholding on Interest and Dividends and Expanded Interest Reporting

Given its direct effect on almost the entire tax paying public, the 10% domestic withholding tax garnered national headlines. The outrage the public expressed over government withholding on their savings equated with the outrage of financial intermediaries over the nightmare implementation would bring. Although the issue of withholding is a moot point now, repeal does not preclude revisitation. Indeed, when initially introduced, few individuals thought the "old chestnut" had a ghost's chance of passage. It is worth recalling some of the major problems with withholding as envisioned under TEFRA.

Of all the problems faced by financial intermediaries, original issue discount (OID) identification was first and foremost. The temporary regulations for both withholding and expanded interest reporting imposed requirements with respect to OID instruments that could not be complied with by financial intermediaries. It was a generally acknowledged fact that the financial community could not comply with the less extensive pre-TEFRA reporting requirements for OID issues. Simply stated, there is not one single reference source identifying those securities issued at a discount. The drafters of the regulations foresaw a "cascading" reporting system whereby the issuing corporation via a 1099 at year-end would alert securities firms that they were the owners of record of an OID during the past year. The securities firm, in turn, using its "highly sophisticated" computer capabilities would backtrack to identify the customers that held the OIDs. This was not feasible as firms cannot backtrack electronically into their systems. Finally, IRS was given the responsibility for publishing the OID listing. Industry and the IRS are currently working on producing an accurate list.

The withholding provisions did not parallel the reporting provisions in some cases necessitating a vast expansion of the items of information that were to be stored via systems and giving rise to considerable confusion. For example, the rules applied differently depending on whether the obligation was short- or long-term, in bearer or registered form, paid or did not pay interest and whether it was transferred or held to maturity by the original purchaser.

A host of other problems was contained in the preliminary withholding regulations. Unclaimed interest and dividends were to be withheld on immediately as though the payee were non-exempt. However, many of these funds are claimed within a period of months and are paid to exempt intermediaries. The delayed deposit rule, seemingly to compensate intermediaries for the cost of implementing withholding, was to be applied according to size of the intermediary, small, medium or large, over a one, two or three year period. However, the securities industry was classified as "large" and thereby entitled to a float for only one year. In addition, the securities industry was denied the election, which had been granted to other financial intermediaries, to defer withholding on certain types of accounts to year-end.

Information Returns of Broker

While not wrought with the complexities encompassed by withholding, the initial regulations on information returns of brokers were not without problems. Brokers were to report the repayment of borrowed securities and the cost of the property used for repayment. The broker, however, does not necessarily have this cost information. In addition, the proposed reporting of futures and commodities transactions required instituting a set of cumbersome procedures which would have required changes in the very conduct of day-to-day business.

The foregoing has only highlighted the major problems with the initial regulations for implementing TEFRA. Some of these problems were resolved with the final regulations, and some completely eliminated with the repeal of withholding. As to the remainder, the money and manpower spent by all financial intermediaries in preparing to implement TEFRA cannot be quantified easily. Most assuredly, there will be more money and manpower spent by industry in January, when customers become fully aware of the extent of TEFRA. The massive sweep of TEFRA and the time frame allotted for start-up virtually guarantee disruption for the financial services industry, the taxpayer and the IRS. Finally, one must question whether placing additional costs and burdens on the private sector to raise modest amounts of revenues is the most cost effective approach to reducing triple digit deficits.

Backup Withholding

The repeal of withholding while welcomed by all financial intermediaries left in its wake expanded provisions for backup withholding. To be sure, backup withholding to catch the taxpayer reluctant to give a social security number or purposely providing an incorrect number is a reasonable measure. However, the proposed manner of implementation, as detailed in the temporary regulations, leaves much to be desired.

The temporary regulations impose a $50 fine on financial intermediaries each time they fail to provide the IRS with a customer's correct social security number. The fine would be levied instead on the taxpayer if the intermediary could prove it had exercised "due diligence" in attempting to obtain the number. It is the due diligence requirements that are particularly harsh. Although couched in terms of options, in essence financial intermediaries will be required to canvass their entire customer base for certification of social security numbers by year-end. In the case of missing or incorrect social security numbers, notification would have to be sent by separate, first class mail.

The required mailings will be extremely costly and appear unnecessarily inflexible. It is, in fact, rumored that some financial intermediaries would risk the $50 fine per incorrect number rather than undertake the certain expense of the mailings. Other aspects of the temporary regulations are also troublesome. For certification purposes, accounts are to be defined as pre-1984 and post-1983. However, a pre-1984 account is to be defined on the basis of 1983 activity which is unworkable since systems are not designed specifically to backtrack into the year's activity. Government staff has gone so far as to suggest that, in lieu of the 1983 activity test, brokers treat all accounts as new accounts. Such suggestions are simply unacceptable. In addition, starting for 1984 and following years, 1099s must be sent in a separate mailing.

The Outlook*

Historically, the burden of the tax system fell on taxpayers in the first instance, and then on government. That clear allocation of the burden began to erode in 1942 with the introduction of wage withholding. The next major step came in 1962 with the expanded information reporting system for interest and dividends. In each case, the changes shifted the burden from the taxpayer and the government to the third party payor. The 1982 changes continue this trend.

Since enactment of TEFRA, Commissioner of the IRS Egger has testified that the IRS will not seek further legislation to improve taxpayer compliance. Some commentators would go so far as to suggest that Congress has overreacted and provided the IRS with too much authority. From the standpoint of the securities industry, quite a bit of time will be necessary to digest TEFRA. On the other hand, others view the TEFRA legislation as nothing more than a good first step at reducing the compliance problem. Moreover, the repeal of withholding on interest and dividends removed much of the "punch" of TEFRA. While it would be reasonable to suspend efforts to evaluate TEFRA until the system has been in place for several years and there are bona fide compliance estimates for those years, such a respite is unlikely. Preliminary IRS estimates of the compliance gap show a 28% increase from 1981 to 1985, notwithstanding TEFRA. The revenue loss is estimated at $100 billion annually. Coupled with the pressure on government to reduce the Federal deficit, the appeal of improving compliance will probably increase even more sharply over the next few years. Increasing "compliance" is, of course, more popular than raising taxes.

There are many options available for narrowing the compliance gap. One could assume that the repeal of withholding would preclude revisitation, at least politically, for a year or two but certainly not indefinitely. The IRS has repeatedly emphasized the superior effectiveness of withholding. The revival of withholding on interest and dividends remains a future option, as well as the extension of withholding to other areas of income.

The criticism of withholding is dismissed lightly by some in government. Regarding the argument that withholding is burdensome on taxpayers and financial intermediaries, the counterargument is that some taxpayers can avoid estimated taxes through withholding thereby reducing their paperwork. Second, it is argued that withholding is the least intrusive alternative to securing fuller compliance. Treasury estimates that a minimum 200% increase in audits and additional annual costs of $1 billion would be necessary to collect through information reporting the revenue which would be available from 10% withholding.

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* Much of this section is based on three articles by John Andre LeDuc giving an overall assessment of the response of the 97th Congress to tax shelters and to the general problem of taxpayer compliance. These articles appeared in Tax Notes on 1/31/83, 6/20/83, and 7/11/83.

There may be few political stumbling blocks to a revisitation of the reporting of capital gains. The securities industry was successful in its plea for cost effective regulations in 1982 in this area. However, given government's perception of a highly computerized industry, there is nothing to prevent a reinvestigation of systems sophistication in the future. Should gross proceeds reporting prove insufficient at narrowing the estimated capital gains tax gap, this may very well rear its head again. Hopefully, the government will focus on sectors where the compliance rate on capital gains is poorest rather than highest as was done recently.

Broad Perspective on Improving Compliance

Approaches to improving taxpayer compliance run a broad range, from a public education system sponsored by IRS to increasing the risks associated with noncompliance. Although never quantified, part of the compliance problem is thought to stem from the complexity of the tax code and the frequent changes to it. Not that the byzantine structure of the tax code has gone unnoticed. There have been several attempts at reform legislation. However, given a patchwork rather than comprehensive approach, reform legislation has served to exacerbate rather than relieve the complexity of the code.

Comprehensive tax reform is an issue receiving much attention in recent months. Alternatives to our present system include consumption taxes, value added taxes and further refinement of the indexing provisions contained in ERTA. Of particular popularity has been the flat rate tax. In pure theory, a flat rate tax would impose one tax rate across-the-board on all income regardless of the source, thus flattening out the progressive structure of our current system and eliminating all credits, deductions, etc. The obvious trade off of any flat rate proposal is a substantial broadening of the tax base. However, just as the greatest appeal of the flat rate tax lies in its simplicity, its greatest coup would be in emerging from Congress in that form. At this point in time, most observers believe the flat rate tax is an interesting concept but is still a long way off in practice. Thus, we are "stuck" with the present tax structure.

Summary

There is little doubt that noncompliance with U.S. tax law exists. The cause of this noncompliance and what to do about it present complex problems to wrestle with. However, solutions of "what to do about it" have fallen increasingly on the private sector. This need not be the case. For example, the IRS is initiating an experiment whereby demographic informatin will be purchased from marketing and direct-mail firms. The IRS will then match this information on lifestyles with its records to locate families which are not paying enough in income taxes. Surely, there are other programs that could be undertaken by government to seek out the noncompliant taxpayer.

The underlying point to all tax compliance proposals is, of course, the yield that will ultimately be produced. Government estimates of the revenue to be brought in by the new compliance measures give one food for thought. Gross proceeds reporting is estimated at generating additional revenues of $22 million in 1983, $120 million in 1984, and about $920 million in the following three years together. Expanded interest, dividend and OID reporting is to produce $43 million in 1983 and $287 million in 1984, escalating to $1.2 billion in 1987. The revenues garnered by backup withholding are less than $5 million in 1984, $113 million in 1985, and $1.4 billion in the next two years. In sum, the first two TEFRA provisions will generate about $65 million in 1983 and all three measures will produce less than $412 million in 1984. Contrasted with the estimated costs to the private sector and a triple digit deficit, these are indeed paltry sums!

While the system of cross checks and balances may become increasingly elaborate, the basic question remains: will the IRS have sufficient resources to make use of the information received as well as to follow up on the noncompliant taxpayer. In fact, one might question whether there are sufficient resources to adequately use the plethora of information that will be received under TEFRA. Finally, it is sobering to recognize that the recent flurry of legislation in the tax compliance area is based on only estimates using outdated figures. There has been little, if any, review of IRS estimates by the private sector and no reliable estimates of the additional costs TEFRA has imposed on the private sector. This is the least that can be done before additional legislation is initiated aimed at closing the "tax compliance gap" further.

Carolyn Hildebrandt
Associate Director
of Research

SECURITIES INDUSTRY STATISTICS

VOLUME

	AUGUST 1983	YEAR-TO-DATE 1983	AUGUST 1982	YEAR-TO-DATE 1982	% CHG. Y-T-D 1983 - 1982
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	74.2	85.3	76.0	55.2	54.5%
AMEX (MILS.)*	6.3	8.9	5.6	4.3	107.0
NASDAQ (MILS.)*	54.4	63.3	30.9	27.5	130.2
REGIONAL EXCHANGE (MILS.)	11.0	12.2	10.8	7.7	58.4
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	61,555	507,164	46,181	260,410	94.8
AMEX (MILS.)	2,249	22,046	1,213	8,666	154.4
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	6,842	61,962	5,436	37,120	66.9
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	12,203	116,992	12,578	78,945	48.2
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	46.7	44.1	42.8	40.7	--
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	6,801	48,668	8,361	45,512	6.9
AMEX OPTIONS	2,868	24,010	3,994	22,678	5.9
COMMODITY	14,719	93,791	10,826	72,382	29.6

* *MONTHLY AVERAGE*

YIELDS

(MONTHLY AVERAGES)

	SEPTEMBER 1983	SEPTEMBER 1982	BASIS POINT CHANGE
BOND BUYER INDEX (20 BOND)	9.6	10.66	(1.06)
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	12.37*	12.94	(0.57)
Baa CORPORATE	13.55*	15.63	(2.08)
RATIO Aaa CORPS. TO Baa CORPS.	0.91	0.83	0.08
MUNICIPAL BOND YIELDS (MOODY'S)	8.97	9.76	(0.79)

PRICES

(END OF MONTH)

	SEPTEMBER 1983	SEPTEMBER 1982	% CHANGE Sept '83 - Sept '82
DOW JONES INDUSTRIALS	1233.13	896.25	37.6%
STANDARD & POOR'S 500	166.07	120.42	37.9
NYSE COMPOSITE	96.24	69.18	39.1
AMEX MARKET VALUE INDEX	230.28	283.18	(18.7)
VALUE LINE COMPOSITE	199.13	131.95	50.9
NASDAQ COMPOSITE	296.65	187.65	58.1

* Preliminary Figures

MUTUAL FUNDS
(DOLLARS IN MILLIONS)

	AUGUST 1983	Yr.-to-Date 1983	AUGUST 1982	Yr.-to-Date 1982	% Change Y-T-D '83 to Y-T-D '82
NET SALES*	814.3	12,833.4	580.0	2,801.4	358.1%
NET PURCHASE OF COMMON STOCK*	939.6	9,433.3	649.3	407.2	2,216.6
NET PURCHASE OF OTHER SECURITIES*	136.7	1,008.5	717.2	1,662.2	(37.8)
MUTUAL FUND CASH POSITION	8.3	---	11.6	---	--

*EXCLUDES MONEY MARKET, MUNICIPAL BOND AND OPTION FUNDS

MARGIN DEBT

	SEPTEMBER 1983	September 1982	% Change Sept'83-Sept'82
MARGIN DEBT OUTSTANDING ($MILS)	19,760*	10,950	80.5
NET CHANGE IN MARGIN DEBT ($MILS)	8,810	(2,810)	--
% OF ACCOUNTS WITH EQUITY UNDER 40%	9	9	--

* NEW HIGH

UNDERWRITING
(DOLLARS IN MILLIONS)

	AUGUST 1983	Yr.-to-Date 1983	AUGUST 1982	Yr.-to-Date 1982	% Change Aug - Aug	% Change 1983-1982
CORPORATE FINANCING (Gross New Issues)						
Total	6,300	71,946	9,256	41,658	(31.9)	72.7
Common Stock	3,027	28,515	1,490	7,608	103.2	274.8
# Of Common Stock Issues	156	1,035	39	377	300.0	174.5
Preferred Stock	571	6,647	545	3,066	4.8	116.8
# Of Preferred Stock Issues	9	94	8	50	12.5	88.0
Corporate Debt	2,703	36,785	7,221	31,338	62.6	17.4
# Of Corporate Debt Issues	41	436	77	336	(46.8)	29.8
MUNICIPAL FINANCING* (Gross New Issues)						
Total	10,666	79,111	11,401	72,981	(6.4)	8.4
Notes	4,101	26,097	4,766	30,127	(14.0)	(13.4)
Bonds	6,565	55,662	6,635	42,854	(1.1)	29.9
# of Bond Issues	398	4,147	365	2,800	9.0	48.1
Negotiated Bonds	4,523	39,186	4,795	29,506	(5.7)	32.8
Revenue Bonds	4,226	38,511	4,615	29,161	(8.4)	32.1

*Preliminary Figures

These tables were prepared by Sandra Gallier-Philpotts

FINANCIAL DATA FOR NYSE FIRMS DOING A PUBLIC BUSINESS
(MILLIONS OF DOLLARS)

	Second Quarter 1983	Yr.-to-Date 1983	Second Quarter 1982	Yr.-to-Date 1982	% Change 2nd Q. 1983 2nd Q. 1982	% Change Yr.-to-Date 1983-1982
REVENUE						
SECURITIES COMMISSION INCOME	2,391	4,503	1,115	2,272	114.4%	98.2%
REALIZED AND UNREALIZED GAIN OR LOSS IN TRADING AND INVESTMENT	2,028	4,206	1,298	2,370	56.2	77.5
PROFIT OR LOSS FROM UNDERWRITING AND SELLING GROUPS	1,003	1,846	436	796	130.0	131.9
TOTAL REVENUE	7,973	15,162	4,953	9,488	61.0	59.8
TOTAL EXPENSES	6,509	12,405	4,662	9,027	39.6	37.4
NET INCOME BEFORE TAXES	1,464	2,757	291	461	403.1	498.0
PERCENT OF FIRMS SHOWING LOSS	12.4%	--	37.9%	--	--	--

RECENT INTERESTING READING AND STATISTICAL MATERIAL

ITEM	DESCRIPTION	SOURCE
Securities Industry Yearbook 1983-84	Fourth annual edition of a comprehensive statistical guide to the securities industry. Three main sections of the book contain: 1. rankings of firms based on capital, RRs, branch offices and employees; 2. detailed information on individual firms; and 3. key industry and market data.	Publications Dept. SIA 120 Broadway New York, New York $35 members/$50 non-members
Competition in the Investment Banking Industry	In this 177-page book, authors Hayes, Spence and Marks provide a comprehensive analysis of the current competitive structure of the industry. After sketching the history and evolution of investment banking, the patterns of concentration and the strategic and economic factors underlying those patterns are explored.	Harvard University Press Cambridge, Massachusetts and London, England 1983
"Deregulation: Riding the Rapids"	Drawing on a study of companies in five industries that have been deregulated in the past 10 years, author Bleeke describes four successful deregulation strategies and suggests how astute top management can avoid some of the trauma by developing an explicit deregulation agenda well in advance of the event, rethinking relations with customers, considering new roles to play in the market and realigning their organizations accordingly.	The McKinsey Quarterly Summer, 1983
"Winning Strategies for Interstate Banking"	Bank deregulation is taking place through the "back door" in states rather than Congress. States are letting local banks convert into large institutions that can presumably stand up to the money center banks when interstate banking arrives. However, the author points out that few banks have come up with promising strategies for mergers.	Fortune 9/19/83

ITEM	DESCRIPTION	SOURCE
"The Six-Month Underwriting Sweepstakes"	Statistical tables ranking underwriters in corporates, municipals, and syndicated loans. Three method rankings for each category: bonus-credit to lead manager, full credit to lead manager, and full credit to each manager.	Institutional Investor 9/83
"Citibank Takes on Merrill Lynch in the Battle of the Giants"	Brief article explaining the advantages and disadvantages faced by banks and brokers in marketing the central asset account.	Dun's Business Month 10/83
"How to Choose a Discount Broker"	Today, over 2,000 banks offer discount brokerage and their ranks are increasing weekly. Article explains difference between full-service and discounter, as well as the nuances among discounter themselves. Table depicting 30 least expensive firms.	Barron's 10/17/83
"The Trouble with 415s"	Review of SIA position letter to the SEC on Rule 415 and the two studies used to support that position, one conducted by SIA and the other by Opinion Research Corp. SIA believes that debt securities ought to remain under shelf registration as it stands now, but that there ought to be new rules for equity offerings. SIA suggests offerings other than investment grade convertible debt and preferred stock be registered on an issue-by-issue basis, with a minimum time set between filing and effectiveness of the legislation statement.	Investment Dealer's Digest 9/27/83

Securities Industry Trends

ANNUAL SUBSCRIPTION
$30.00 member • $48.00 non-member

AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

A8825-1 12/21/83

Vol. IX No. 6 November 25, 1983

FIRST-HALF 1983: IF ONLY IT COULD CONTINUE!

HIGHLIGHTS

1. In the 1H 1983, annualized after-tax ROE was 31%, exceeding the record 26% for 1980. For full year 1983, we project ROE in the range of 24%-27%, near to or possibly exceeding the highest recorded figure since the mid-sixties.

2. Rising expenses remain of concern. Costs were masked by rapid revenue increases from 1979-1982 and declining interest rates during the 1H 1983. With revenues falling in the 3Q 1983, profits will decline sharply from the 1Q 1983 and 2Q 1983 levels.

3. Employment rose significantly in the securities industry during the 1H 1983. After rising by only 2.5% during 2H 1982, employment jumped nearly 11% to 194,300 by June 30, 1983 for NYSE firms dealing with the public.

4. With activity in the primary and secondary markets at unprecedented levels during the 1H 1983, firm catgories most dependent on this industry's core products -- origination and distribution of securities -- enjoyed the largest spurt in earnings.

5. We estimate that non-deposit taking discount brokers accounted for about 6.3% of retail commissions and 12.6% of retail share volume in 1982. During 1H 1983, discounters' market share amounted to 8.1% of retail commissions and 16.2% of retail share volume. However, their percentage of total industry revenues amounted to only 1.5% as compared to 1.3% in 1982.

6. For the first time in years, concentration in the securities industry declined. Firms other than the largest 25 saw their share of revenues and capital increase from 24% and 27% in 1982 to 26% and 34%, respectively, during 1H 1983.

Introduction

Our preliminary findings for the first half of 1983 were reported on October 12 in a presentation at the Vista Hotel. During that morning, we presented trends for the industry during the first half of 1983 as well as profitability and other trends for various firm categories from 1979 through the first half of 1983. In addition, we introduced the Securities Industry Data Base and explained how it can be used for comparing firm performances and describing trends in the securities industry.

This paper, including tables and graphs, represents a "fleshing out" of the October 12 presentation. In addition to our paper, there is a revised and updated list of discounters who are members of the NYSE, NASD, or both. Because of the widespread interest in trends in the discounter segment of the securities industry, we reviewed earlier listings of such firms and corrected mistakes which were made and included firms that had been inadvertently excluded. Much of the accuracy of our list depended on the cooperation of several discounters and vendors to such firms who have tracked firms in the discounter segment of the business. The discounter list is attached to this Trends issue.

In the June 1 issue, we noted that although recent years were extraordinarily good for the securities industry, there were areas of concern. For one thing, expenses grew at an annual compound rate of 26% from 1979-82. The escalating costs faced by the industry were masked by unusual revenue increases which were growing at a compound annual rate of 27% over the same time period. This led to the troublesome conclusion that if revenue growth fell below 27%, there would be a profit squeeze. Fortunately, revenue growth during the first half of 1983 surpassed even the extraordinary 27%, from 1979 to 1982. Revenues rose 31% on an annualized basis while expenses were increasing 23%. Unfortunately, the 23% increase in expenses, although down from the 1979 to 1982 trend, did not indicate that the industry was coming to grips with expenses. Rather, the industry enjoyed a respite from cost pressures because interest rates were falling, thereby cutting interest expense.

Industry Performance

Profitability

The securities industry has been highly profitable since 1979. In the first-half of 1983, annualized after-tax return on equity (ROE) was 31%, exceeding the record 26% established in 1980.

Securities Industry After-Tax Return on Equity, 1979 to First-Half 1983

1979	1980	1981	1982	First-Half 1983 (Annualized)
15.6%	25.7%	18.9%	21.3%	30.6%

Beginning with the third quarter of 1982, after-tax ROE reached an unprecedented level through the first half of this year. Indeed, the fourth quarter of 1982 may remain a high watermark for this industry in terms of a convergence of desirable market forces boosting industry revenues and profitability. The only period resembling the prosperity of the fourth quarter of 1982 for the securities industry was the second quarter of 1980 when annualized after-tax ROE reached 39%.

Quarterly Annualized After-Tax Return on Equity, 1Q 1982-2Q 1983

1982					1983		
I	II	III	IV	Year	I	II	Half-Year
5.4%	9.0%	28.4%	42.8%	21.3%	29.8%	31.2%	30.6%

Revenues

This jump in profitability in the 1H 1983 is partially explained by the spurt in total revenue. On an annualized basis, revenues rose 31% relative to 1982 (Table 1). The climb in industry revenue occurred essentially because of lower interest rates compared to 1982 and expectations that rates would not rise substantially (Table 2). Nevertheless, there remained some concern over interest rates because M1 growth exceeded the Federal Reserve's target range while GNP accelerated in the second quarter at an annualized real rate of 9.7%.

Various revenue sources grew at different rates during the 1H 1983. From 1981 to 1982, only margin interest revenues showed a decline. This decline continued during the 1H 1983. Other-related revenue, which was the fastest growing revenue source from 1979-82 -- 50% -- actually fell 2% during the 1H 1983 (see Charts I and II). Commissions, in particular, showed the most improvement in revenue growth during the 1H 1983. Whereas commissions rose 14% at a compound annual rate from 1979-82, this revenue source rose almost 50% on an annualized basis during the 1H 1983.

Table 1

Securities Industry Revenue Breakdown, 1982 and First-Half 1983
(Millions of Dollars)

	1982		1H 1983	
REVENUES*	Dollars	% of Total	Dollars	% of Total
Commissions				
Listed Equities on an Exchange	$ 4,492.0	19.3%	$ 3,305.6	21.8%
Listed Options	741.0	3.2	415.1	2.7
All Other	792.0	3.4	785.2	5.1
Total	6,025.0	25.9	4,506.0	29.7
Trading Profits				
Market Making OTC	658.0	2.8	810.2	5.3
Debt Securities	4,463.0	19.2	2,393.8	15.8
All Other	839.0	3.6	533.3	3.5
Total	5,960.0	25.7	3,732.6	24.6
Investment Profits	598.0	2.6	480.3	3.2
Underwriting				
Equity Securities	330.0	1.4	367.6	2.4
Total	2,322.0	10.0	1,852.6	12.2
Margin Interest	2,016.0	8.7	860.7	5.7
Mutual Fund Sales	290.0	1.2	602.8	4.0
Account Supervision	359.0	1.5	245.3	1.6
Research	25.0	0.1	9.3	0.1
Commodities	669.0	2.9	436.9	2.9
Other - Related	3,945.0	17.0	1,933.4	12.7
Other - Unrelated	1,051.0	4.5	518.7	3.4
GROSS REVENUE	$23,244.0	100.0%	$15,179.0	100.0%

* Discrepancies may exist due to rounding.

Source: Securities Industry Data Base

Table 2

Selected Interest Rates and Inflation Indexes, Second-Half 1982 and First-Half 1983

	Interest Rates				Inflation Indexes	
	Federal Funds	3 to 5 Year Governments	New AAA Bonds	20 Year Governments	Producer Price Index*	Consumer Price Index**
1982:III	11.01%	13.00%	14.09%	12.94%	6.4%	7.6%
1982:IV	9.29	10.31	11.07	10.72	4.2	2.0
1983:I	8.65	9.95	11.22	10.87	(2.6)	(0.4)
1983:II	8.80	10.07	10.58	10.81	0.8	4.2

* Producer Price Index - Finished Consumer Goods
** Consumer Price Index - All Urban Consumers

Volume and share prices rose during the 1H 1983. Average daily share volume on the NYSE, AMEX and NASDAQ totaled 104 million in 1982, but climbed to 163 million shares in the 1H 1983 (Table 3). The Dow Jones Industrial average which ended 1982 at 1046.54 increased nearly 17% to 1221.96 by the end of the 1H 1983. Volume climbed because of both institutional and retail customers' participation. Blocks of 10,000 shares or more as a percentage of NYSE reported volume, an indicator of institutional activity, rose to nearly 44% of public volume or 4.8 billion shares during the 1H 1983 compared to 41% or 6.7 billion shares for all of 1982. Increased interest by retail investors was reflected by NASDAQ activity which doubled from an average of 33 million shares per day in 1982 to nearly 66 million shares in the 1H 1983.

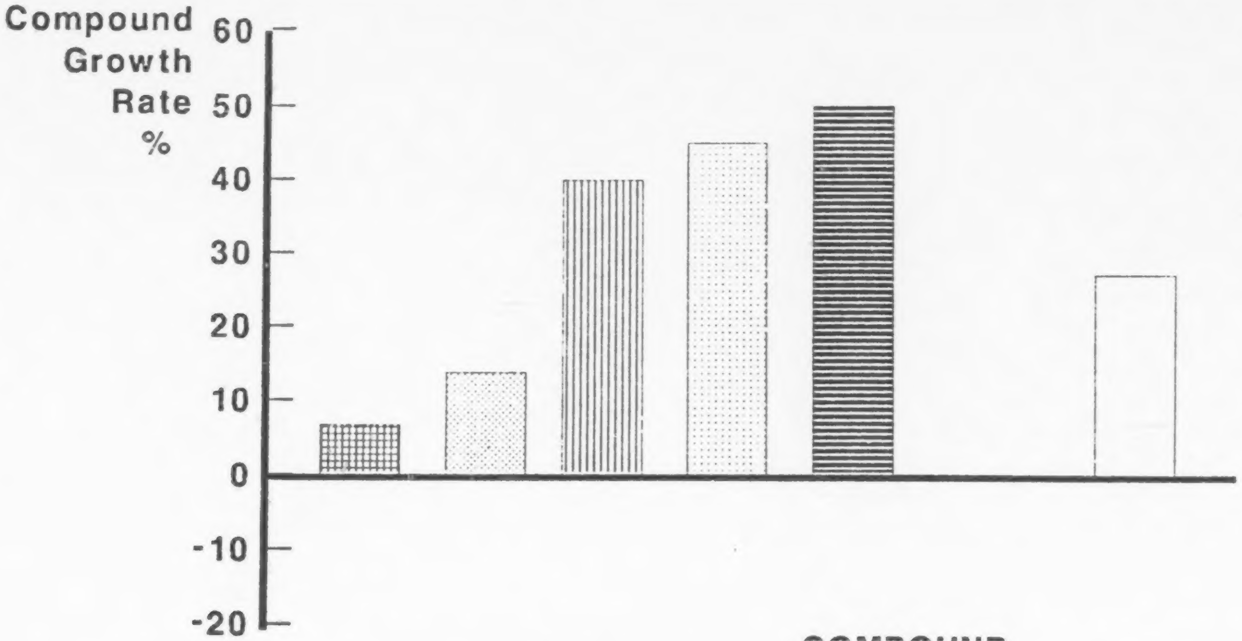
Table 3

Average Daily Share Volume, 1982 and First-Half 1983
(In Millions of Shares)

	1982		First-Half 1983	
	Shares	Percent	Shares	Percent
NYSE	65.1	62.8%	88.1	54.0%
AMEX	5.3	5.1	9.5	5.8
NASDAQ	33.3	32.1	65.6	40.2
	103.7	100.0%	163.1	100.0%

Chart I

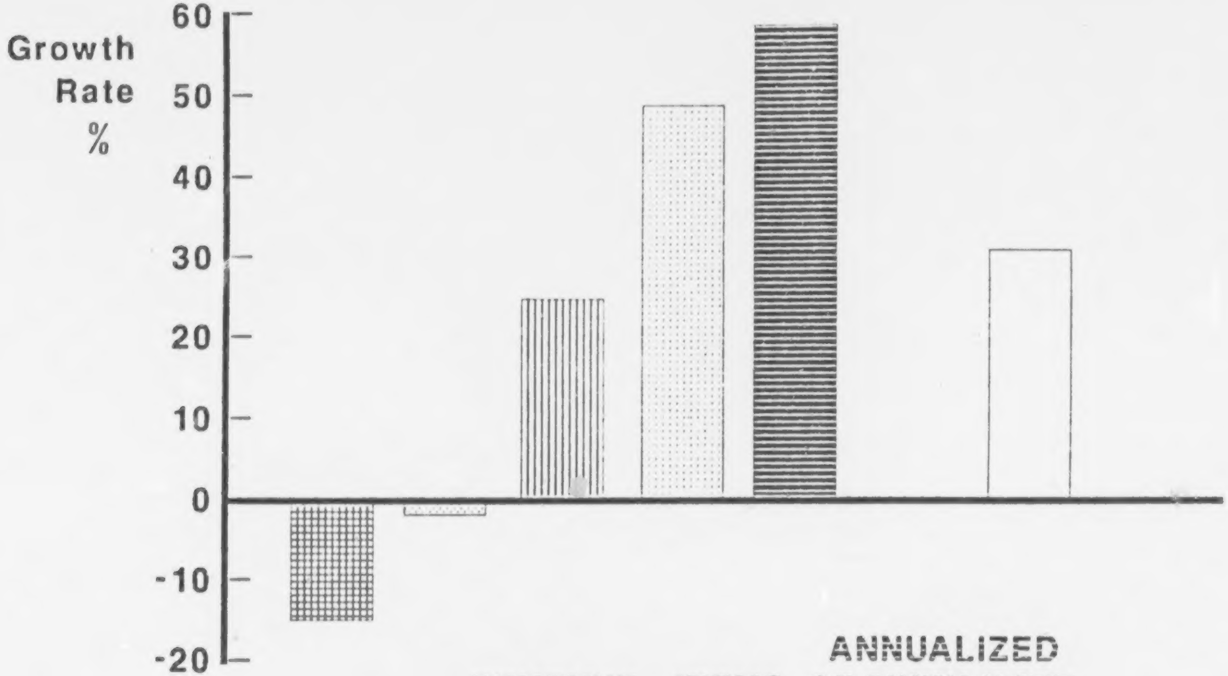
COMPOUND GROWTH RATES OF REVENUES, 1979-1982



	REVENUE ITEMS	COMPOUND GROWTH RATE
▦	MARGIN INTEREST	7 %
░	COMMISSIONS	14
▥	TRADING	40
░	UNDERWRITING	45
▤	OTHER RELATED	50
☐	TOTAL REVENUE	27 %

Chart II

ANNUALIZED GROWTH RATES OF REVENUES, FIRST-HALF 1983



	REVENUE ITEMS	ANNUALIZED GROWTH RATE
▦	MARGIN INTEREST	(15) %
░	OTHER RELATED	(2)
▥	TRADING	25
⬚	COMMISSIONS	49
▤	UNDERWRITING	59
□	TOTAL REVENUE	31 %

Trading Profits

The increase in trading profits, one of the fastest growing revenue sources from 1979-1982, slowed down in the 1H 1983. Such profits climbed 40% in 1982 compared to an annualized rate of 25% during the 1H 1983. As a result, it fell from being as large a revenue source as commissions in 1982, to second in importance for the 1H 1983. Debt instruments, the largest component of trading profits, generated profits rising at an annualized rate of only 7% (Table 4) because interest rates were relatively stable in the 1Q 1983 and rose during the 2Q 1983.1/ However, trading profits from OTC market-making activities soared at an annualized rate of 146% as the NASDAQ Composite Price Index, after reaching its trough of 167.35 in July 1982, spurted to 318.70 by June, 1983.

Table 4

Securities Industry Trading Profits
(Millions of Dollars)

	1982		1983						Annualized Percent Increase, 1982 to 1H 1983
	Year		I		II		First Half		
	$	% of Total	$	% of Total	$	% of Total	$	% of Total	
Market Making OTC	$ 658	11.0%	$ 355	18.1%	$ 455	25.7%	$ 810	21.7%	146.3%
Debt	4,463	74.9	1,366	70.0	1,058	59.8	2,394	64.1	7.2
Options on Nat'l Exch.	7	0.1	12	0.6	27	1.5	39	1.0	1000.1
Other	735	12.3	266	13.5	229	12.9	494	13.2	18.3
Total	$5,960	100.0%	$1,964	100.0%	$1,769	100.0%	$3,733	100.0%	25.3%

Underwriting

Underwriting revenue climbed at a 59% annualized rate in the 1H 1983 after increasing by 45% in 1982. Corporate financings reached an annual high in 1982 at $79 billion. However, this total will be swamped in 1983 with $61 billion worth of offerings already completed by June 30, 1983. Of the $61 billion,

---

1/ Interest received on debt positions contributed to this slowdown since trading profits reported on FOCUS include accrued interest and rates were at a lower level in 1983 relative to 1982.

Table 5

Corporate Underwriting Activity, 1982 and First-Half 1983*
(In Billions of Dollars)

	1982		First-Half 1983	
	Dollars	Percent	Dollars	Percent
Common Stocks	$16.5	20.9%	$22.2	36.3%
Preferred Stocks	5.3	6.7	5.8	9.4
Bonds	57.2	72.4	33.2	54.3
	$79.0	100.0%	$61.1	100.0%

* Includes all underwritten Yankee bonds and Alaska State Housing taxable securities.

Source: Directory of Corporate Financing, Dealers' Digest Inc., 1982 and Semi-Annual 1983.

$33 billion in debt was raised with just under $15 billion coming from issues registered under Rule 415. The remainder was comprised of $5.8 billion from preferred stock sales and $22.2 billion generated by common stock offerings. Particularly impressive was the value of money raised via initial public offerings, IPOs (Table 6).

Table 6

Initial Public Offerings
(000's omitted)

First Half	Amount	No. of Issues
1983	$4,568,241	243
1982	719,256	129
1981	2,214,585	282
1980	446,661	96
1979	254,858	59

Source: Directory of Corporate Financing, Dealers' Digest Inc., September 1983, p. 17.

The high level of activity persisted because of the decline in the cost of capital and the need by companies to restructure their balance sheets. Corporations had taken on an unusually high proportion of short-term debt in recent years because of high interest rates and low equity prices. At the end of 1982, nonfinancial corporate business liabilities included nearly 49% of short-term debt/credit market debt, an historical high. The increased reliance on equity offerings -- 46% of all underwriting for the 1H 1983 -- (28% in 1982) was particularly significant.

Margin Interest

Margin interest revenue fell 15% in the 1H 1983 after plunging 30% in 1982. However, the important variable for firm profits is not gross margin interest revenue but net margin interest income which cannot be calculated because of the limited available data. Nevertheless, data are available for NYSE customer margin debit balances, estimated rates charged margin customers, the broker call rate, and free credit balances. Although data are not available on cash debits against which free credit balances are also used or revenue earned on stocks bought on margin, the available data might indicate the trend in net margin interest income. Firms may not have been as adversely affected in 1982 as reflected by the drop in gross margin interest revenue because while margin debit balances decreased 15%, free credit balances rose nearly 30% (Table 7). As a result, net margin interest income may have risen while gross margin interest revenue fell. Since customer margin debit balances climbed 25% while free credit balances increased 23% during the 1H 1983, net margin interest income probably increased.

Table 7

Indicators of Net Margin Interest Income*
(In Billions of Dollars)

	NYSE Customer Margin Debit Balances	Free Credit Balances	Average Broker Call Rate	Estimated Rate Charged Margin Customer
1981	$14.20	$ 9.04	17.85%	19.35%
1982	12.04	11.65	13.43	14.90
1H 1983	15.08	14.36	9.70	11.05

* All data are averages.

Other-Related

Other-related revenues to the securities business include interest on repos, M&A fees, private placement fees, and other sources. These revenue sources declined at an annualized rate of

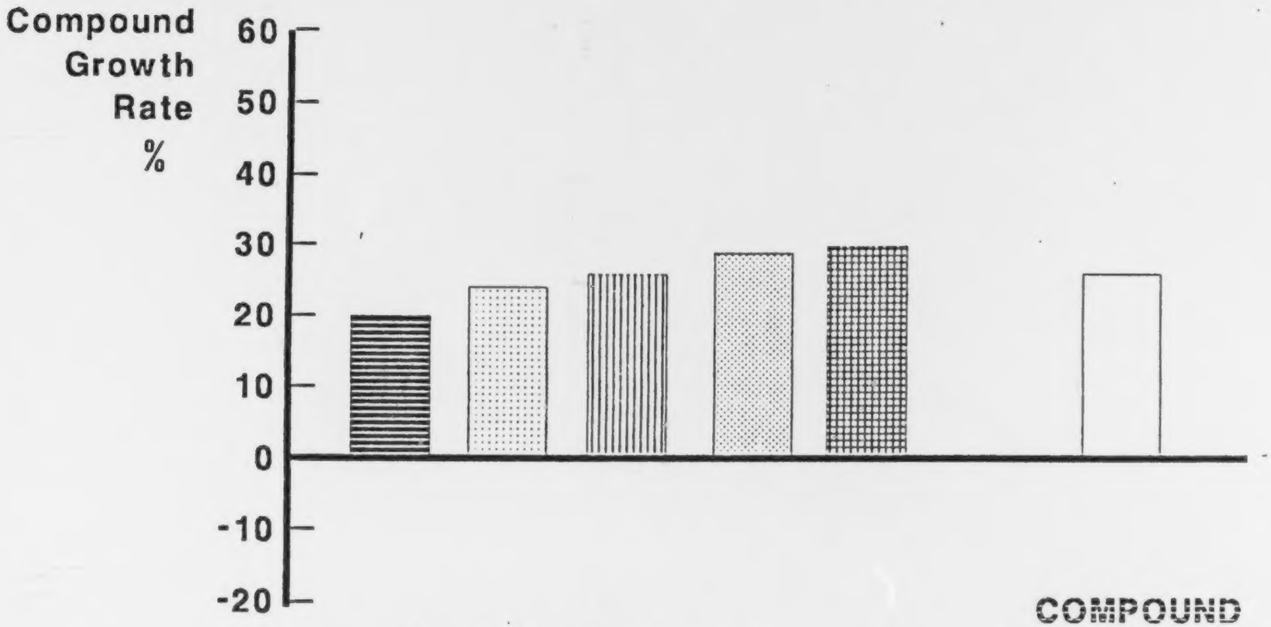
2% in the 1H 1983 after climbing 33% in 1982. Interest on repos is believed to be the largest component of this revenue item and is probably responsible for the decrease as interest rates fell. However, just like net margin interest income, net interest income on repos is the important concept rather than gross interest figure because much of the repo business is based on matching transactions between lenders and borrowers. The annualized increase for the 1H 1983 for fees from both M&A activities as well as private placements probably exceeded those for 1982. M&A activity, as reported by W.T. Grimm, was $31.4 billion during the 1H 1983 compared to $53.8 billion for all of 1982, and private placements amounted to $12.4 billion during the 1H 1983 compared to $19.9 billion in 1982.

Expenses

Expenses were escalating nearly as fast as revenues during 1979-1982, and, as indicated in the June, 1983 Trends issue, threatening industry profitability (Chart III). The difference between revenue and cost increases widened during the 1H 1983 boosting ROE to a record level. Revenue increased at an annualized rate of 31% while expenses rose 23% (Table 8). However, the increase in costs is masked by declining interest costs (Chart IV). Interest costs were the only expense to decrease, falling 9% at an annualized rate. Excluding interest expense, total costs climbed at an annualized rate of 35%. However, lower interest rates also reduce certain revenue sources. Total revenue, excluding margin interest, also increased at an annualized rate of 35%. Unfortunately, other interest-related revenue sources such as interest on repos and fixed income instruments carried as inventories cannot be computed from FOCUS data. Thus, we are unable to adjust revenue trends for interest rate fluctuations to analyze the underlying cost trends relating to revenues. Nevertheless, the limited adjustment for interest rate fluctuations continues to support our concern over costs.

Chart III

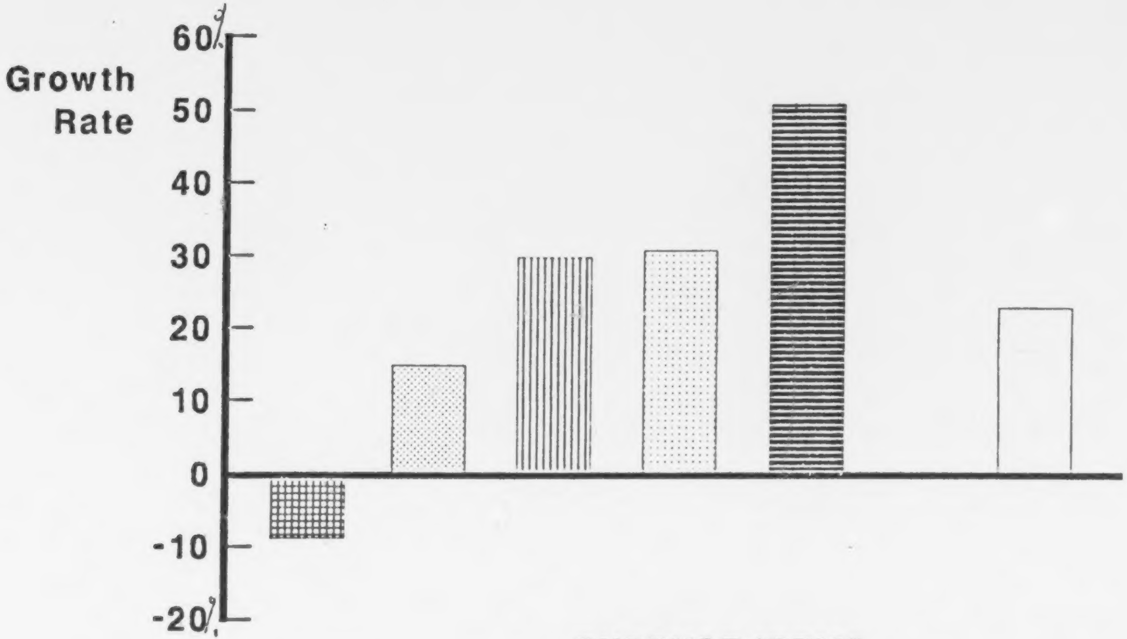
COMPOUND GROWTH RATES OF EXPENSES, 1979-1982



	EXPENSE ITEMS	COMPOUND GROWTH RATE
▤	INTEREST	20%
░	COMMUNICATIONS	24
▥	ADMINISTRATIVE & CLERICAL EMPLOYEE EXPENSES	26
▒	REGISTERED REP. COMPENSATION	29
▦	OTHER	30
☐	TOTAL EXPENSES	26%

Chart IV

ANNUALIZED GROWTH RATE OF EXPENSES, FIRST-HALF 1983



	EXPENSE ITEMS	ANNUALIZED GROWTH RATE
▦	INTEREST	(9) %
░	COMMUNICATIONS	15
▥	ADMINISTRATIVE & CLERICAL EMPLOYEE EXPENSES	30
⋯	OTHER	31
☰	REGISTERED REP. COMPENSATION	51
☐	TOTAL EXPENSES	23 %

Table 8

Securities Industry Expense Breakdown, First-Half 1983*
(Millions of Dollars)

EXPENSES	Dollars	Percent of Revenue	Annualized Percent Increase
Floor Brokerage & Clearance	$ 530.8	3.5%	21.1%
Registered Rep. Compensation	3,106.2	20.5	51.0
Clerical & Administrative	2,421.7	16.0	30.5
Communications	735.8	4.8	15.4
Occupancy & Equipment	530.2	3.5	23.9
Promotional Costs	329.9	2.2	23.8
Interest	2,494.7	16.4	(8.9)
Losses in Error Accts. & Bad Debts	125.8	0.8	28.4
EDP Equipment Costs	161.0	1.1	17.0
Regulatory Fees & Expenses	60.7	0.4	17.9
Partners' & Voting Stockholders' Salaries	501.0	3.3	31.3
Other	1,141.3	7.5	32.0
Total	$12,416.4	81.8%	23.1%

* Discrepancies may exist due to rounding.

Source: Securities Industry Data Base

Significant increases occurred in variable as well as so-called fixed costs although the latter showed some signs of slowing down. Registered representative compensation jumped by an annualized 51%. Since account executives are compensated from three different revenue sources -- commissions, underwriting, and principal activities -- it is impossible to determine the payout ratio from FOCUS. Clerical and administrative expenses, a hybrid item which includes both variable and fixed costs, rose at the same rate as total revenue. Employee expenses climbed at a high rate compared to revenues. A jump in total employment significantly contributed to this higher cost. Employment for NYSE firms dealing with the public, excluding introducing firms,[2] rose only 2.5% during the last six months of 1982 to 175,600. During the first-half of 1983, employment climbed nearly 11% to 194,300. Apparently, the industry was slow to hire additional employees during the first stages of the recovery. As the boom in volume and security prices continued, employees were added. Among the so-called fixed costs, large annualized increases continued although below their 1979-1982 increases. Occupancy and equipment, communications, and EDP equipment expenses all rose at slower

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2/ No data on employment trends are required on FOCUS for such firms.

rates in 1983 relative to 1979-82.

Other Industry Trends

Volatility

As indicated, the securities industry remains volatile in terms of profitability swings. Of the 17 quarter-to-quarter swings in ROE since 1979, 10 were in an upward direction while 7 were down (see Chart V). A key factor causing this volatility, of course, is the swing in total revenue from quarter to quarter. In just examining the 1Q 1982-2Q 1983, a comparison of the troughs and peaks by revenue source shows that total revenue was up over 75% when comparing the high (2Q 1983) with the low (1Q 1982). Individual revenue sources were even more volatile. The peak in underwriting was almost three times the trough. For trading, the peak was almost twice as large as the trough and for commissions, it was more than twice the low for that revenue source. Of the five revenue sources analyzed, two peaked in the 2Q 1983, two in the 4Q 1982, and one during the 1Q 1982. Given the volatility of various revenue sources, it is not surprising that total revenue also fluctuates widely from quarter to quarter, thereby causing sharp swings in ROE.

Impact of Interest Rates

Recently, some individuals in the industry noted that, since the securities industry performed well in a period of relatively high interest rates and inflation, a drop in interest rates may hurt rather than help the securities industry. Clearly, such comments are incorrect. The industry enjoyed a boom in profitability with the drop in interest rates starting with the second half of 1982. Profitability has since soared, reaching an unprecedented level for four consecutive quarters starting with the third quarter of 1982.

Expenses as well as revenues are affected by changing interest rates. From 1979 to 1982, total expense grew at a compound annual rate of 26% with interest cost increasing at a rate of 20%. Meanwhile, total revenue annually increased 27%. During the first-half of 1983, total annualized costs were up 23% as interest cost dropped 9%. Total revenue climbed 31%. If not for the decline in interest cost, annualized total expense would have risen 35% during the first-half of 1983.

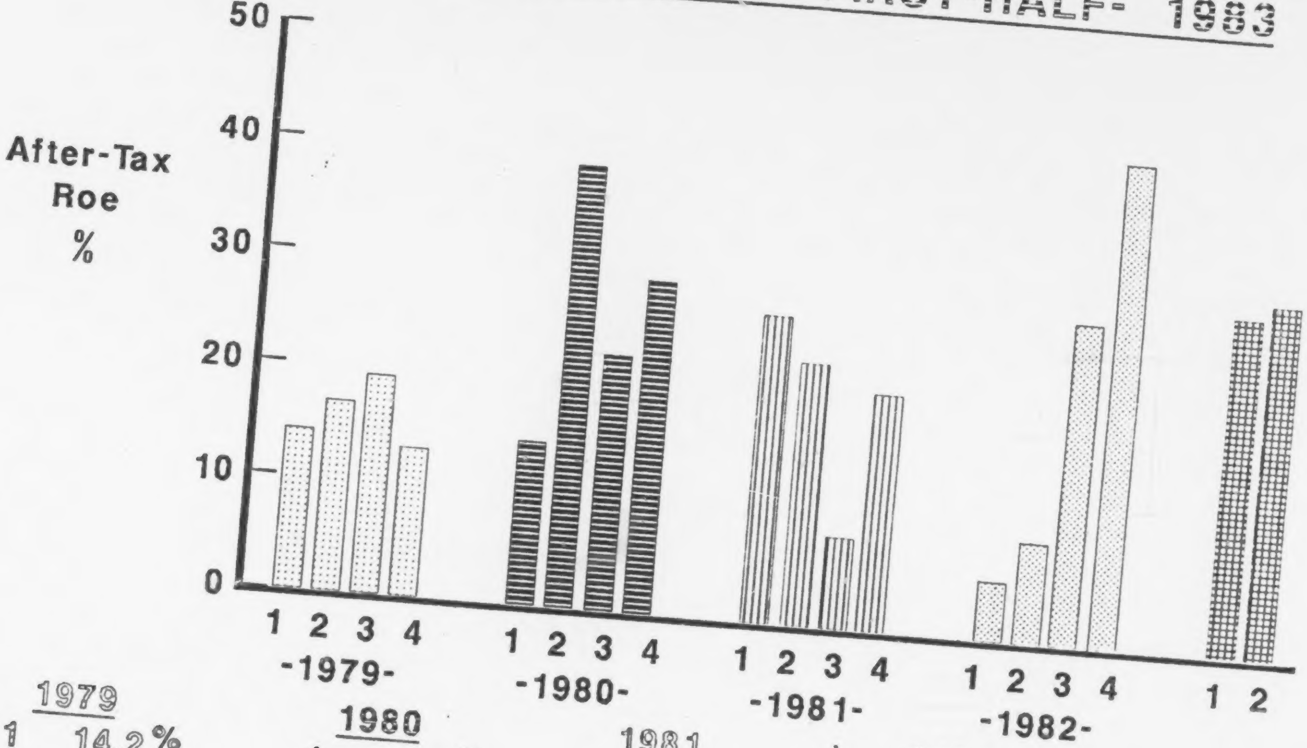
Given the fact that the decline in interest rates spurred securities prices and volume, new offerings of debt and equity, and caused a decline in the growth of costs, lower interest rates are crucial to the profitability of the securities industry.

Outside Capital

The impressive ROE figures are attracting "outsiders." In recent years, other financial intermediaries have shown a growing

Chart V

SECURITIES INDUSTRY QUARTERLY ANNUALIZED AFTER-TAX RETURN-ON-EQUITY, 1979-FIRST-HALF- 1983



	1979	1980	1981	1982	1983
1	14.2 %	14.5 %	27.1%	5.4 %	29.9 %
2	16.8	39.1	23.2	9.0	31.2
3	19.3	22.6	8.1	28.4	
4	13.1	29.3	20.9	42.8	

interest in the securities industry's profitability and have sought to obtain entry into this industry, either through direct purchase or de novo entry. Insurance companies, in particular, have linked up with securities firms and commercial banks have been aggressive in pursuing additional investment banking business as well as securities brokerage. Of course, these appetites may undergo a dramatic change if and when hard times fall on this industry as in the early 1970s. At that time, there was little interest by outsiders in an industry that was starving for capital and seeing its revenue sources contracting.

Firm Categories

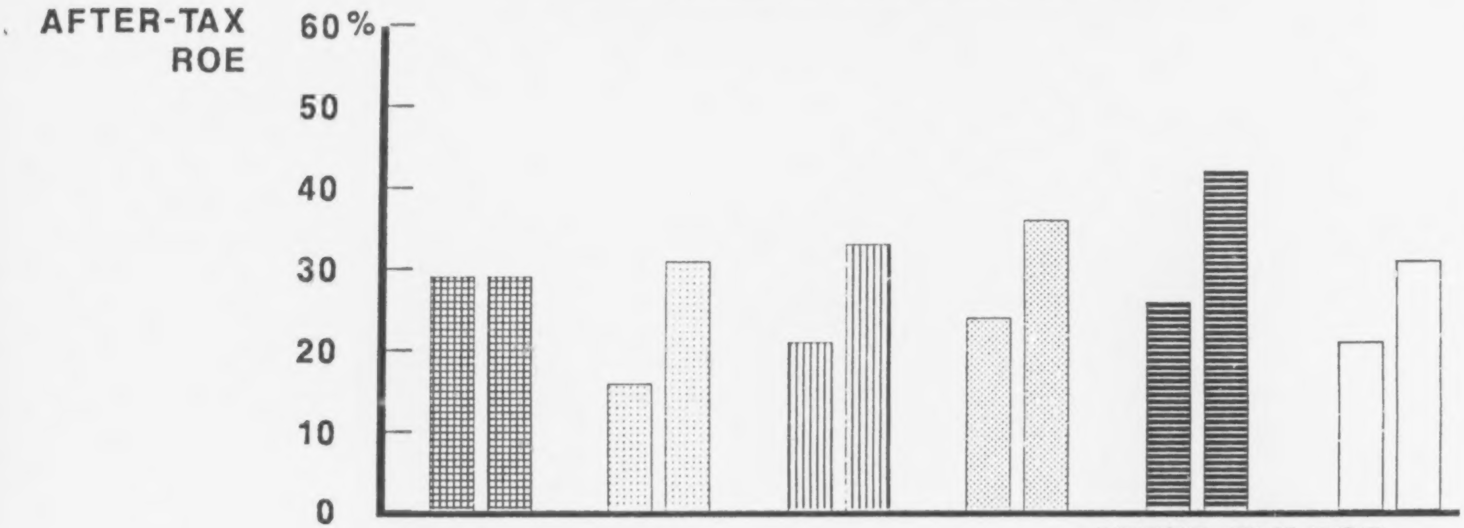
Those firm categories least dependent on traditional core products of this industry -- origination, distribution and selling of securities -- were the most profitable in 1982. During the first half of 1983, the reverse was true. Those firms most dependent on traditional core products were most profitable, while those emphasizing other products and services showed the least improvement from 1982.

When conditions in the securities markets are strong, all firm categories prosper. Likewise, when conditions in the financial markets deteriorate, all firm categories suffer to some extent, although one group may fare better than others. In other words, much of the performance of the industry and, in particular, individual firms, may be outside management control. Nevertheless, with revenue growth slowing down in the third quarter, more and more firms are focusing on the need to control costs. It is frustrating for management to scrutinize every expense item closely and to make strenuous efforts to gain additional or, at least, retain market share while much of what affects a firm's profitability is outside its direct control. This is particularly true when monetary policy in the country undergoes an abrupt change or fiscal policy is unbalanced because of spending and taxation policy. Nevertheless, the overall profitability in this industry from 1979 through the 1H 1983, when most other sectors of the economy were buffetted by inflation and low or zero growth, augers well for the creativity, flexibility and judgment of industry leaders.

Last year, the securities industry earned an estimated 21% ROE after income taxes. This represented a remarkable turnaround given that annualized ROE for the first and second quarters were 5.4% and 9.0%, respectively. With the market rally igniting in mid-August, all elements of the securities industry enjoyed a surge in profitability. For the year, the large investment bankers received the highest ROE (29%) compared to the low for national full line firms (16%) (see Chart VI). Following the large investment bankers were discounters (26%), New York City regional firms (24%), and regionals (21%). All of these categories, except the large investment bankers, enjoyed a substantial increase in ROE during the first half of 1983. The national full line firms almost doubled their ROE from 16% in

Chart VI

AFTER-TAX RETURN-ON-EQUITY BY FIRM CATEGORY, 1982 AND FIRST-HALF 1983



		AFTER-TAX ROE	
	FIRM CATEGORIES	1982	FIRST-HALF 1983 ANNUALIZED
▦	LARGE INVESTMENT BANKING	29%	29%
░	NATIONAL FULL-LINE	16	31
▥	REGIONALS	21	33
▒	NEW YORK CITY	24	36
▤	DISCOUNTERS	26	42
□	SECURITIES INDUSTRY	21%	31%

1982, to 31% for the first-half of 1983. Only the largest investment bankers did not show any increase, but their ROE of 29% during both of these periods was nothing to sneeze at. On a relative basis, the rankings of all firm categories improved by 1, except the large investment bankers who fell from #1 in 1982 to #5 during the first half of 1983. With activity in the primary and secondary markets at unprecedented levels, those firms most dependent on volume and security prices enjoyed the largest spurt in earnings.

Earlier, we noted that macro factors affect all firms in the securities industry in much the same manner (Chart VII). Almost all firm categories had their ROE trough in the 1Q 1982. Conversely, the ROE peak for all firms was the 4Q 1982. Of all the firm categories, the large investment banking firms had the smallest difference between their ROE trough and peak. Their lowest annualized ROE during this time period was 15.2% in the 1Q 1982 compared to their high of 43.8% during the 4Q 1982. With an ROE of 66.6% by discounters during the 4Q 1982, it is not surprising to find outsiders rushing into the discount brokerage business. The performance of the discount segment closely tracks that of the New York City area firms. These two firm categories are more dependent on the commission business, particularly from retail customers. Their clientele tends to be the more sophisticated, active trader.

Discounters

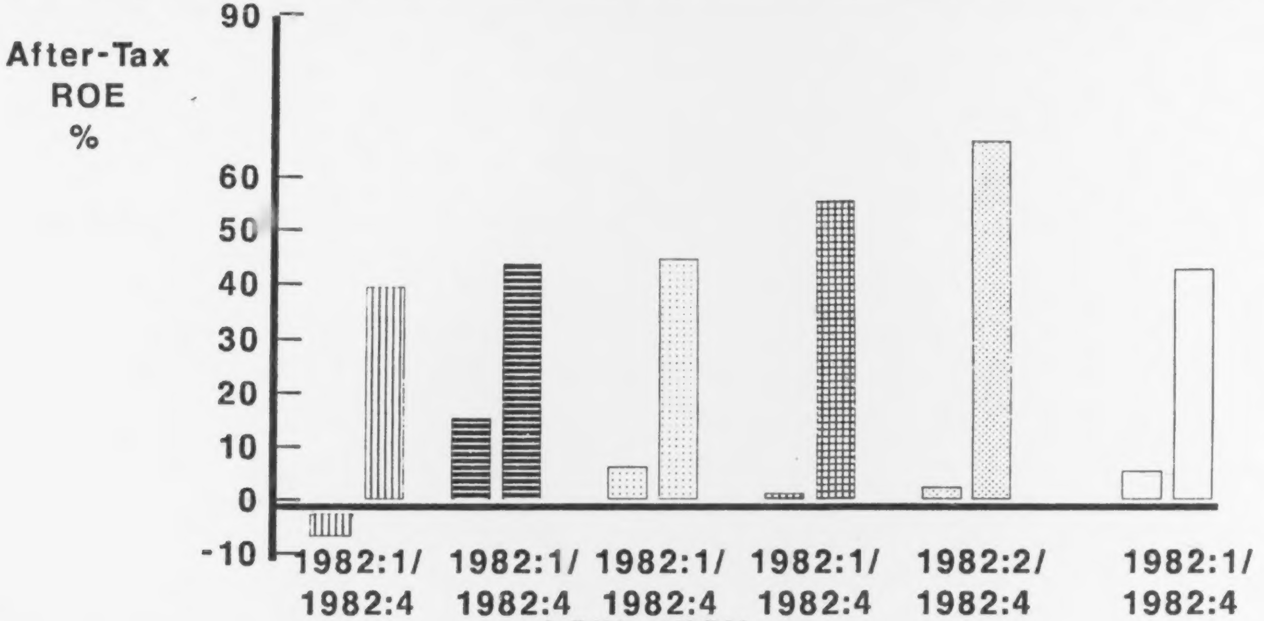
There continues to be widespread interest within and outside the securities industry about discounters. Because of this, as in other issues of Trends, we thought it helpful to provide revenue data for the discounter category. Unfortunately, our data are limited to discounters that are members of the NYSE. However, with the cooperation of the NASD, we obtained aggregate figures on those sole NASD members who are discounters. Thus, we estimated trends in market share of discounters relative to other firms in the securities industry. At some time in the near future, we expect to provide detailed data on all discounters, whether or not they are members of the NYSE or NASD.

Unfortunately, there are no available data on the activities of deposit-taking institutions who provide discount brokerage services through their banking organizations. This is a glaring problem, particularly for the regulatory agencies who are responsible for reviewing and deciding on the permissible activities of deposit-taking institutions and securities firms. Such data are becoming more essential given the recent SEC release requesting comments concerning that agency's proposal to regulate the securities activities of banks. Simply put, there are no reliable numbers on the level of activity in discount brokerage provided by deposit-taking institutions.

Compiling an accurate and thorough discounter list is a painstaking task. Although a list was compiled by the SEC for their annual "Staff Report" on the Securities Industry, we found

Chart VII

LOW AND HIGH QUARTERLY ANNUALIZED AFTER-TAX RETURN-ON-EQUITY BY FIRM CATEGORY, 1982-FIRST-HALF 1983



		LOW	HIGH
▥	NATIONAL FULL-LINE	(0.9)%	35.5%
▤	LARGE INVESTMENT BANKING	15.2	43.8
░	REGIONALS	6.2	44.7
▦	NEW YORK CITY	1.4	55.5
▒	DISCOUNTERS	2.4	66.6
□	SECURITIES INDUSTRY	5.4 %	42.8 %

errors in the inclusion of many firms and others which were inadvertently excluded. Because of these problems, some of the conclusions contained in the SEC staff reports about discounters are incorrect. In particular, there are mistakes in profitability reported for NYSE discounters relative to other NYSE firms dealing with the public. Although there remains some problems with market share trends of discounters, those estimates are of less concern relative to the profitability comparisons.

We believe such errors have been eliminated by our attempts to compile a new discounter list. In particular, we relied on several discounter firms to review our list and note firms that were omitted or incorrectly included. Without such cooperation, we would be less confident in our results. We believe the profitability data and income statement for NYSE discounters is accurate and our estimates of market share for all non-deposit taking discounters is as accurate as possible given data limitations.

In the past, individuals interested in trends in discount brokers relied on the annual SEC staff reports on the securities industry. The 1979 and 1980 staff reports, in particular, displayed data on discount brokers, their profitability, revenue growth and comparison with other segments of the securities industry. With completion of the 1980 report, the SEC reduced its reporting on trends in the securities industry because of budget limitations. Since the 1980 report, SIA has attempted to fill this vacuum by analyzing trends for discount brokers as well as their market share in terms of retail commissions and retail share volume.3/ Unfortunately, our detailed analysis of discount brokers is restricted to trends beginning with the first quarter of 1982. Since our detailed information on discounters and other securities firms are limited to NYSE members, there were not enough discounter members of the NYSE before 1982 to warrant analyzing this group. With the cooperation of the NASD, we supplemented our detailed information of NYSE discounters with aggregate information for sole NASD discount brokers. Thus, we can provide a detailed income statement for NYSE discount firms and an analysis on the market share of all discounters including NASD sole members.

In reviewing the earlier SEC reports on profitability, their estimates show discounters with ROEs considerably higher than other firm categories. Because of errors in the original SEC list, we believe their analysis is flawed. Our figures show discounters were more profitable in 1982 and in the 1H 1983 relative to the rest of the industry. Nevertheless, these profitability comparisons do not show discounters considerably above other categories but rather close to that of New York City

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3/ Our first attempts at doing this were reflected in the March 4, 1983 issue of Trends entitled "A Primer on Discount Brokerage" as well as our update on 1982 published in June, 1983.

based regional firms. Given the revenue sources for these groups, it is logical that both discounters and New York City based regionals have similar profitability patterns. Commissions rose from nearly 70% of discounters' total revenue in 1982 to almost 80% for the 1H 1983 (Table 9). Meanwhile, although expenses climbed 62% in 1982 and 50% for the 1H 1983 on an annualized basis, these increases were less than those for revenues. Profitability gains were particularly impressive. Pre-tax profit margins improved from 13% in 1982 to nearly 19% for the 1H 1983. After-tax ROE rose from 26% in 1982 to 42% for the 1H 1983 on an annualized basis.

Table 9

NYSE Discounters' Income Statement
(In Millions of Dollars)

	1982		First-Half 1983	
	Dollars	Percent of Total	Dollars	Percent of Total
Commissions	$153.0	68.9%	$139.0	78.0%
Trading Profits	1.9	0.9	2.9	1.6
Underwriting	2.0	0.9	1.2	0.7
Margin Interest	37.0	16.7	14.9	8.4
Other - Related to Securities Business	10.1	4.5	9.8	5.4
All Other	18.2	8.2	10.4	5.8
Total Revenues	$222.2	100.0%	$178.2	100.0%
Net Income Before Taxes	$ 29.8		$ 33.4	

Source: Securities Industry Data Base

Discounters' market share of commissions also increased. The NYSE and NASD discounters received $244 million in commissions in 1982, compared to $7.1 billion for all firms dealing with the public. In terms of total revenue, discounters received $363 million as compared to $27.3 billion for the entire industry. In the 1H 1983, commissions received by discounters amounted to $193 million compared to $5.3 billion for the industry. Discounters received $261 million in total revenue compared to $17.8 billion for all NYSE and NASD members dealing with the public.

Table 10

NYSE and NASD Discounters' Market Share,
1982 to First-Half 1983
(In Millions of Dollars)

	1982	1H 1983
Industry Commissions	$7,091	$5,283
Estimated Retail Commissions	$3,091	$2,377
Discounters' Commissions	$244	$193
Discounters' Market Share of Retail Commissions	6.3%	8.1%
Industry Gross Revenues	$27,336	$17,803
Discounters' Gross Revenue	$363	$261
Discounters' Market Share of Gross Revenues	1.3%	1.5%

When analyzing the discounter category, most individuals are interested in their share of retail commissions and retail share volume. Unfortunately, there is no recent breakdown available on the proportion of commissions generated by retail versus institutional accounts. To estimate market share, we used a proxy for retail and institutional activity.4/

We esimated that retail commissions accounted for 55% in total commissions for 1982, but only 45% for the 1H 1983. By assuming that all discounter commission revenues is derived from retail activity, we estimate that discounters received 6.3% of retail commissions in 1982 and 8.1% in 1H 1983. If we assume discounters charge about half the rate of full service firms, they accounted for about 12.6% of retail activity in 1982 and

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4/ The last year for which the SEC collected data on commission rate charges for institutional and retail orders was 1981. To estimate this proportion for 1982 and the first half of 1983, we used the following methodology: first, we subtracted 10,000 share blocks and member trading as a percentage of NYSE volume. We took the ratio of "retail" volume to total NYSE volume in 1981 and compared that to the breakdown available for the SEC survey -- 65% of total commissions were generated from retail activity and 35% from institutional trading. We assumed that the same ratio would more or less hold for later periods. In other words,

$$\frac{\text{"Retail NYSE activity in 1981"}}{\text{"Retail NYSE activity in year Y"}} : \frac{.65}{X}$$

16.2% during the 1H 1983.

As indicated in the March 1983 Trends issue, although discounters are increasing their market penetration in the retail commission business, their share of the total revenue pie in the securities business is considerably smaller. Although discounters have increased their market share of retail commissions and share volume, their market share in terms of total securities revenue hardly changed at all. Their $363 million in revenues in 1982 amounted to only 1.3% of the industry's 1982 total revenue. During the first half of 1983, this percentage increased slightly to 1.5%. Because broker-dealers have diversified substantially in recent years and introduced a vast array of new products and services, the penetration of discount brokers in the total activities of the securities industry remains relatively small.

There continues to be no evidence of economies of scale in the securities industry in terms of profitability. In 1982, the smaller firms outperformed the larger firms. In 1983, with the vigorous rise in activity during the first half, smaller firms continued to outperform the larger firms. Of course, given the smaller number of firms in the top 10 or in group 11-25, a few relatively less profitable concerns will drag down the profitability for the group as a whole.

Table 11

After-Tax Return on Equity, by Firm Size

	1982	Annualized 1H 1983
Top 10	21.5%	28.4%
11-25	19.1	32.2
Rest of Industry	22.5	33.6

Concentration

Many commentators on the industry still have the misconception that the securities industry has been both consolidating and becoming more concentrated since the early 1970s. Actually, since 1978 the securities industry has been expanding. Indeed, the number of NYSE firms dealing with the public increased slightly that year as did the NASD membership. Since 1979, the number of NYSE and NASD members has been increasing.

Although the consolidation of the industry stopped about 1978, concentration continued to grow. The largest firms increased their share of total revenues, commission revenues and total capital. In effect, the big continued to get bigger through 1982 (Table 12). This trend was reversed in the first half of 1983 with the boom in activity and securities prices. Whereas firms other than the largest 25 continued to more or less hold their own in commission revenues from 1978-1982, their slice of total revenue and total capital decreased through 1982. In the first half of 1983, their market share increased noticeably in both gross revenues and total capital. This reflected the profitability enjoyed by smaller firms during this time period and investments by other financial intermediaries in regional firms.

Table 12

Concentration Data, 1979-First Half 1983

	1979	1980	1981	1982	1H 1983
1. Total Revenue					
Top 10	48.7%	53.1%	55.6%	57.3%	54.4%
Top 11-25	18.6	19.4	18.7	18.7	19.7
Rest of Industry	32.7	27.5	25.8	23.9	26.0
	100.0%	100.0%	100.0%	100.0%	100.0%
2. Commissions					
Top 10	40.0%	43.6%	43.4%	42.8%	42.6%
Top 11-25	20.0	21.1	20.8	20.9	21.0
Rest of Industry	40.0	35.1	35.8	36.4	36.4
	100.0%	100.0%	100.0%	100.0%	100.0%
3. Total Capital					
Top 10	45.8%	50.8%	50.0%	54.8%	48.8%
Top 11-25	18.8	18.0	19.7	18.3	17.1
Rest of Industry	35.4	31.1	30.3	26.9	34.1
	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Securities Industry Data Base

Summing up, 1978 was the benchmark year when the consolidation of the securities industry was halted. For those who believe that the securities markets will be healthier with more players in that market, 1983 may well turn out to be the year where the industry became less rather than more concentrated. Nevertheless, before becoming too optimistic, we should see what happens to market share as business slows down in the 2H 1983. At the very least, we may have reached the point where further concentration in the securities industry more or less stopped.

Conclusion

The third quarter reports of publicly owned broker-dealers are trickling in. In general, these show that profitability fell relative to the 1H 1983. However, starting with the third quarter of 1982, the securities industry enjoyed a period unparalleled in revenues and profitability. These trends could not be expected to continue indefinitely.

Our earlier concerns expressed in the June issue have, unfortunately, been right on the mark. With revenue growth slowing down in the third quarter, it was just a matter of time until the higher level of costs would put a lid on industry profits. Fortunately, profitability in the latter part of 1982, through the first half of 1983, has left the industry with a stronger and larger capital base.

Although profitability for all segments of the industry are expected to be down in the third and fourth quarters, certain segments will perform better than others. In particular, firms for whom trading activity is especially important will face a more difficult period. In comparison, firms emphasizing retail activity including underwriting of equities will do better than others. Although volume may be down relative to the 1H 1983, 3Q 1983 exceeded 4Q 1982 activity. Thus, we expect lower profits in the third and fourth quarters relative to the 1H 1983, but they should be around the level in the 3Q 1982. In other words, we expect 1983 to be a record year with revenues in the $28-$31 billion range. Our best guess is that after-tax ROE will range between 24-27%, possibly exceeding the all-time high of 25.7% in 1980.

Now that the securities industry data base is "live," analysis in the future will be available faster. Moreover, as other individuals use the data base, the analysis of the securities industry should improve dramatically. This development is welcomed by all individuals in the industry as well as policymakers.

Jeffrey M. Schaefer Senior Vice President and Director of Research	Ira Epstein Assistant Director of Research

LIST OF DISCOUNT BROKERAGE OPERATIONS AS OF AUGUST 1983

Abbot Securities
Adams, Harkness & Hill
Adams, James, Foor & Co., Inc.
Advest, Inc.
Allen & Company

Allied Securities Corp.
American Commercial Securities Corp.
C. D. Anderson & Company
Anderson, Tallman & King
Arbour Securities

Argus Securities
Aristo Investment of America
Arlington Inter-Urban Securities
Arnold Securities
Baker & Company

Barclay Financial Corp.
BBS Equities (Bevill, Bresler & Schulman, Inc.)
Berlind Securities
Bishop, Ramirez-Simsco., Inc. Investment Securities
Richard Blackman & Company

Blinder, Robinson & Co., Inc.
Brokers Exchange, Inc.
Brooks-Campbell & Co., Inc.
Brown & Company Securities Corp.
Bruno & Stolze

Burke, Christensen & Lewis Securities Corp.
Alan Bush Brokerage Company
W. T. Cabe & Company
William Cadden & Company, Inc.
Capital Discount Brokerage, Inc.

Capital Express Corp.
Capitalquest Securities, Inc.
Carnegie Investor Services, Inc. (sub. of Gilford Securities)
Chayka & Loeb
Clayton, Polleys & Company

Julien Collins & Company
Columbine Securities
Commission Discount Corp.
S. C. Costa Company
Crailin & Company (formerly Forbes, Walsh & Kelly)

Daley & Company
Marquette deBary Co., Inc.
Dis-Com Securities
Discount Brokerage Corporation of America
Discount Investments of America (Subs. of Home Savings)

Dominick & Dominick
Downstate Discount
Eastern Capital
Eastwest Securities Company
Elliott Securities, Inc.

W. N. Estes & Co., Inc.
Exchange Services
Fidelity Brokerage Services, Inc.
John Finn & Company
First Affiliated Securities, Inc.

First Birmingham Securities Corp.
First Discount Securities
First Georgetown Securities
First National Securities (formerly First Omaha Securities)
First Union Discount Brokerage Services

Freeman Welwood & Company
FSC Securities Corp.
Goodson Securities
Grimm & Davis (Div. of Douglas Stewart)
Haas Securities

Haigney Securities
Heartland Securities
Heitner Equities
Heritage Investment Securities, Inc.
Jerome Hickey Associates

Icahn & Company
Individual's Financial Services, Inc.
Individual's Securities
Intrawest
Investacorp, Inc.

Investors Associates Incorporated
Kall & Company
Kashner Securities Corp.
Kenneth Kass & Company, Inc.
Kennedy, Cabot & Company

KO Securities
Kramer Securities Corp.
R. F. Lafferty & Company, Inc.
LaSalle Street Securities, Inc.
Lind-Waldock

Liss, Tenner & Goldberg
Little & Company
Madduff & Sons
Marsh, Block
M. H. Meyerson & Co., Inc.

Mpact Brokers, Inc.
MSR Securities, Inc.
Barry W. Murphy & Company
Oberweis Securities, Inc.
Odd Lots Securities, Ltd.

Olde & Company
Ovest Securities, Inc.
Pace Securities
Pacific Brokerage Services
Packard & Lewis (Div. of Haas Securities)

Park Avenue Securities
Parker, Alexander & Co.
Parr Securities
Andrew Peck Associates
Pennsylvania Group

Peremel & Company
Portfolio Securities Transactions Corp.
Quick & Reilly
Recom Securities
Remsnyder & Company

Reynders, Grey & Company, Inc.
Riko Securities
Roberts Securities Corp.
Robinson Securities (Div. of John Dawson & Assoc.)
Rodecker & Co. Investment Brokers

Rose & Company
Rosenkrantz, Ehrenkrantz, Lyon & Ross
Royal Investors Group
Russo Securities, Inc.
St. Louis Discount Securities, Inc.

Salem Securities Inc.
Charles Schwab & Company
Scottsdale Securities
Sea-First Discount Brokerage
Seaport Securities Corp.

Seasongood & Mayer
Security 1st Brokerage Services
J. D. Siebert & Company, Inc.
J. Robert Sheeks & Company
Shearman, Ralson, Inc.

Shochet Securities
Muriel Siebert & Company, Inc.
Springer Investment & Securities
Stock & Trade
Stock Cross

The Stock Mart
Stock Service Corp.
Texas Securities, Inc.
Robert Thomas Securities
Tradex Brokerage Service, Inc.

Triad Securities
Max Ule
Underhill Associates
Universal Securities Corp.
Verelli, Altschuler & Schwartz, Inc.

Voss & Company
Wall Street Discount
Walnut Securities
Waterhouse Securities
Werlitz Securities, Inc.

Werbel-Roth Securities
Western Discount Securities
Westminister Securities Corp.
Jack White & Company
Thomas F. White & Company

Whitehall Securities
Wisconsin Discount Securities
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DEREGULATION: OPPORTUNITIES AND PITFALLS

A Summary of Presentations at the 1984 Trends Conference*

The theme of the 1984 Trends Conference was "Deregulation: Opportunities and Pitfalls." This issue of Trends will summarize the conference speakers' remarks concerning deregulation in the financial services industry.

The conference addressed a large number of issues and questions, theoretical and strategic, facing the financial services industry. The most fundamental questions are: (1) what economic and structural changes has the securities industry undergone since price deregulation in 1975?; (2) what are the factors presently encouraging further deregulation in the financial services industry?; (3) how does competition in the deregulated financial services industry differ from earlier competitive trends in the securities industry?; (4) what do all the economic and structural changes in the financial services industry mean in terms of firm strategies?; and (5) how can securities firms successfully compete in the broader financial services industry environment?

The conference theme was reflected in Donald Waite's presentation "Analyzing Concepts and Strategies in Deregulated Industries." Representatives of the four types of firms Waite discussed followed with presentations focusing on strategies in a deregulated environment: Bob Rittereiser of Merrill Lynch on the national firm, Ned Johnson of Fidelity on discounters, John Castle of DLJ on the specialty firm, and Bob Woodberry of Sutro on the regional firm. Charles Brown of AT&T was the keynote luncheon speaker discussing "AT&T After Divestiture." The afternoon session focused on three strategies in obtaining capital and distribution. Chip Mason of Legg Mason spoke on "Going Public," Bobby Piper of Piper Jaffray discussed "Linking with Another Organization," and Don Kittell of Dean Witter discussed "Merging." The conference concluded with remarks by Albert Gordon (Kidder, Peabody) and Ed O'Brien (SIA). Gordon placed the issues presently facing the securities industry in a broader historical perspective, while O'Brien, looking towards the future, was optimistic that the securities industry will exploit the opportunities presently facing it.

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* The full transcript of the 1984 Trends Conference is available at $50. Conference registrants can still obtain copies at $25. An order form is enclosed.

Introductory remarks to the day's program were provided by Jeffrey M. Schaefer (SIA). According to Schaefer, the securities industry recently entered another stage of deregulation, characterized by the crumbling of barriers between different segments of the financial services industry. This trend is related to the great growth in industry revenues and profitability that has occurred despite the deregulation of fixed commission rates in May, 1975. Other financial intermediaries have noticed these trends and decided to enter and compete for securities activities.

ALTERNATIVE STRATEGIES UNDER DEREGULATION

Frederick J. Wilten (Pru-Bache) introduced the topic of alternative strategies under deregulation. Wilten highlighted how firms in the financial services industry can successfully compete in a deregulated environment. He addressed two questions: How did deregulation of commission rates in 1975 affect the securities industry, and what are some of the factors encouraging further deregulation?

The first phase of securities industry deregulation concerned how firms were going to compete while the second phase will determine where they are going to compete. The rigid barriers to financial industry segmentation are crumbling with banks and securities firms entering each others businesses. According to Wilten, the driving force behind this second phase of deregulation results from banks and securities firms responding to weaknesses in their core businesses.

"Analyzing Concepts and Strategies in Deregulated Industries"

Waite (McKinsey & Co.)

Waite's presentation focused on the strategies most likely to be effective given the economics, structure and dynamics of the present-day deregulated financial services industry. Deregulation for the securities industry occurred in May 1975 when fixed commission rates for stock transactions were eliminated. This price deregulation had many important consequences: industry profitability and rate of return declined as the most profitable products/services were affected; products/services were unbundled and new products/services proliferated; and the variability in performance among firms increased.

According to Waite, profound structural changes occurred in the deregulated environment in three phases. The first occurred around the years surrounding the dramatic price deregulation (1973-1978) and consisted of the merging of some second-tier firms to compete against the largest firms. As a result, the industry became more concentrated. In the second phase (1978-1980), the largest firms got bigger by acquiring certain specialty firms to round out their products and services, again increasing industry concentration. With the third phase (beginning in the early 1980s), firms outside the industry combined with some of the traditional industry participants.

In addition to the macro analysis of securities industry deregulation, Waite also provided a firm-level analysis. According to Waite, in a regulated environment, most firms compete directly in core markets by offering traditional services. Under deregulation, firms begin to differentiate themselves, and compete by offering different products/services at varying prices. Four types of firms emerge from this differentiation process: the national distribution firm, the single product firm, the specialty firm, and the regional firm. Waite provides an analysis of each of those types of firms and the options available to them in a deregulated environment.

Competition in the disaggregated environment requires firms to identify all the business they are in, and those where they have a competitive advantage and disadvantage. Firms must determine which of their businesses are linked and which can stand alone in order to determine which business can be eliminated without affecting other businesses. Firms should evaluate whether they can substantially alter the economics of their businesses, by either changing their cost system or by other arrangements, such as leasing businesses or by combining distribution systems. Given resource constraints, firms should evaluate their ability to reallocate their resources and what business(es) to emphasize. Waite stressed that the strategic options available to firms are both quite limited and difficult. In the present environment of rapid change and great discontinuity, Waite concludes that it is both more difficult but also more necessary to plan.

SPECIFIC STRATEGIES

Peter Muratore of E.F. Hutton introduced panelists representing the four kinds of firms which emerge in the differentiation process under deregulation. Deregulation cannot be thought of as a simple phenomena. First, different firms experience deregulation at various times, and its impact varies by firm, being both an opportunity and a threat. Asset management, according to Muratore, has been the strategy adopted by Hutton in the deregulated environment.

"The National Full Line Firm"
Rittereiser (Merrill Lynch)

Rittereiser indicated that during the 1969-1982 period, Merrill Lynch (ML) was driven by a growth diversification strategy. ML expanded its capital markets business primarily with internally generated activities, entered the insurance and real estate fields, and developed more products aimed at cementing relationships, such as the CMA.

According to Rittereiser, regulatory barriers are eroding and will continue to do so in the future. Banks are entering the discount brokerage market. Rule 415 has greatly impacted the underwriting business. Legislation in 1982 virtually put the Depository Institutions Deregulation Committee (DIDC) in the role of a product designer for the banking industry.

For Rittereiser, the rapid developments in computer hardware and software technology are putting information and computing power closer to the end user, and driving information and financial services closer together in the consumer's mind. This trend will, for many firms in the financial services industry, drive processing costs down, and give them the opportunity to create new delivery systems.

ML also realized that it was no longer competing only against traditional brokers but also against many financial giants with capital, management, good reputations, who employ sophisticated technology, and have large customer bases.

ML sees the next few years as a volatile transition period for the financial services industry, a period during which ML can solidify its position. Though competition will be intense over the next few years, many of ML's competitors will be unable, for a number of reasons, to fully compete with ML.

Rittereiser concluded that ML has major opportunities to continue growing. In looking at future strategy, it comes down to what are you going to do about your situation. A strategic plan is a variety of ways of getting things done to handle the position you are in.

"The Discounter"
Johnson (Fidelity)

Before discussing the discounter, Johnson made three general observations concerning some of the themes previously discussed. First, he does not believe that the financial services industry lends itself to the model of corporate planning applicable to industrial corporations. Second, deregulation has already occurred and is history. Third, a far more important issue is how computer technology has increased the capital requirements and made the industry much more capital-intensive.

According to Johnson, when deregulation first began, different groups saw it having different effects: the break up of the biggest institutions; an enormous opportunity; fears that the consumer would lose government protection; severe price competition which would be self-destructive.

For Johnson, "discounting" is doing something for less money than somebody else doing the same thing. On the basis of that definition of "discounting," Johnson denies that Fidelity is in the discounting business since it is not providing the same service as everybody else. Fidelity offers different kinds of services based on different marketing techniques, described as passive selling techniques. Fidelity does not use sales representatives, but various media to sell their products/services.

According to Johnson, Fidelity's overriding strategy is to bring products to market that are good for the customer and Fidelity, distributed through multiple channels which are flexible and efficient. They sell a portfolio of products customers will buy in all sorts of market conditions. These products are sold through mass advertising, telephone sales, banks, and regional investor centers.

"The Specialty Firm"
Castle (DLJ)

Castle believes that the securities industry is far too complex to fit neatly into the model presented by Waite. Most major securities firms fall into more than one of the four basic firm categories. DLJ, for one, is both a specialty type firm and a firm that has low-cost firm characteristics. In terms of how DLJ has measured up to the ideal planning responses to deregulation as outlined by Waite, Castle believes that DLJ must be given a mixed evaluation. Their record of planning for and coping with deregulation is uneven, but they are improving all the time, and will do better in the future.

Castle discusses the impact of three deregulatory events on DLJ: elimination of fixed commission rates, passage of ERISA, and the easing of Regulation Q. According to Castle, DLJ's response was a function of its history and character. DLJ was hit hard with the great decline in institutional rates during the 1970s. Early in the 1970s, they realized that they could not rely solely on institutional business, and would have to diversify.

The institutional business remained the core of DLJ and the price cutting on institutional trades following Mayday was resisted. DLJ paid dearly for adopting that strategy in terms of market share and profitability. Those fims willing to move with the flow of events faired best. With the decline in commission rates, institutional trading grew tremendously and the large wirehouses entered this market. New low-cost producers entered the market competing primarily on price.

With the passage of ERISA, eliminating the ability of securities firms with money management units to do their brokerage in-house, DLJ came very close to divesting Alliance Capital in 1977. However, DLJ decided to keep Alliance Capital and all trades by Alliance were distributed to other brokerage firms. This was a wise decision since Alliance's assets under management have grown 3 1/2 times since 1977. Alliance is now the largest Wall Street pension fund manager, produces a lot of commissions for other brokerage firms, and has contributed to DLJ's growth.

The DLJ that emerged out of the turmoil of the 1970s was strongly established in four principal areas of business: debt and equity trading on behalf of institutional clients, investment management for institutional customers, the correspondent brokerage system, investment banking and venture capital. DLJ added a fifth business line in 1981 when it acquired an international commodities trading firm.

DLJ is essentially a specialty firm -- a firm providing specialized, differentiated services in areas where it can make a unique contribution. In certain respects, it does not fit the McKinsey model. It evolved into a specialty firm -- not by retrenchment but by expanding into new specialty areas. DLJ expanded more through acquisitions than by internally generated growth.

"The Regional Firm"
Woodberry (Sutro)

According to Woodberry, Sutro is a small regional firm, nearly 100% owned by its employees and associates. It has a low cost operation with a good reputation. However, its processing subsidiary was only 60% owned by Sutro; the sales force is small and productivity is low; capital, inadequate. Although clearly a regional firm, Sutro would like to be a specialty firm, in a small way. Their strategy, according to Woodberry, is two-pronged. They want to remain a strong full-service regional firm; and do certain things that specialty type firms do.

To implement this strategy, Sutro bought out the 40% outside ownership of their processing subsidiary; broadened their capital from $6 million to $14 million; decided to concentrate on California only; increased their California offices to 22; tried to enhance their reputation; substantially increased the quantity and quality of their sales force; continued to put money into their operation facilities; and embarked on improving their research. They are trying to use their research product to enhance their corporate development while trying to increase institutional sales.

Thomas A. Saunders (Morgan Stanley) introduced Charles L. Brown, who spoke on AT&T after divestiture. Saunders indicated that on a worldwide basis no industry is being more deregulated than telecommunications. Charles L. Brown is leading AT&T into the new deregulated environment. As a result of deregulation, AT&T has already expanded its telecommunications activities worldwide, and has gotten into computers and software.

"AT&T AFTER DIVESTITURE"

Brown (AT&T)

The AT&T divestiture was, according to Brown, the product of government preference for competition and deregulation. What makes AT&T really uneasy is that the government has only slightly deregulated AT&T, while AT&T's competitors were deregulated to begin with. AT&T, according to Brown, is facing both regulation and competition. Brown indicates that AT&T long distance business, which accounts for about 60% of their revenue in 1983, is still fully regulated. Brown believes that there is little justification for regulation of the long distance business. He indicated that AT&T will press hard for deregulation of the long distance market. Brown hopes that competition will bring to the customer the benefits claimed.

According to Brown, AT&T management is flexible and ready to develop new strategies and to make changes according to circumstances. There is no resistance to change at AT&T. They are doing what needs to be done. Brown indicates that AT&T has already taken the following actions: an offshore strategy, which is vital to the continued funding of Bell Labs and to a good revenue steam. There are joint ventures with Phillips, and Olivetti; AT&T's large equity interest in Korea's Gold Star Company and they are now negotiating to set up a majority owned venture in Taiwan for marketing switching systems.

At home, Brown indicates, AT&T has adopted a new distribution system -- 7,000 retail stores. They believe phones will be distributed in the future this way. They are increasingly moving into a multi-functional apparatus for the home, like the Genesis System.

The competitive environment has forced them to reduce costs where necessary by closing plants and consolidating distribution facilities. They have made major structural changes: for example, they have combined their R&D with manufacturing sectors. Bell Labs is still the centerpiece of AT&T. Bell Labs, combined with AT&T marketing and production resources, provides the underpinning for the products and equipment that will be brought to the market in the new environment.

Brown indicates that AT&T's financial goals have changed to reflect their new situation. Their financial goal now is to maximize the value of their shareowners' investment. In the past, their earnings were capped by regulation, but for a large part of the business the cap is now off. They will be striving to reach a return on equity higher than was acceptable to investors in pre-divestiture days.

STRATEGIES IN OBTAINING CAPITAL AND DISTRIBUTION

Alan F. Blanchard (Goldman, Sachs) introduced the first topic of the afternoon session, strategies in obtaining capital and distribution. Blanchard thinks that merging, linking with another firm, or going public represent strategies for dealing with the new deregulated environment. According to Blanchard, many firms in the securities industry have adopted one of these three strategies. From his 1980 list of 154 securities firms, consisting of 90% of the industry in terms of equity, 14 firms have gone public or raised additional equity money, 20 have merged, and 9 have linked.

The use of these strategies is even greater, according to Blanchard, if measured in terms of firm resources. The important question is why have so many firms decided to employ these strategies. One reason, according to Blanchard, is money. Firms that have either gone public, merged, or linked have received a lot of value, measured in four ways: dollars per book dollar, dollars per earning dollar, dollars per RR, dollars per branch.

"Going Public"

Mason (Legg Mason Wood Walker)

As an introduction to how Legg Mason made its decision to go public, Mason described his firm's corporate strategy. Legg Mason is basically a retail brokerage firm which must remain big enough so that they can compete in new products. They must stay in their own market and make money for their customers without undue risk. They have built their philosophy around value stocks -- stocks with low P/E values. They believe that the difference between them and very large firms will be that Legg Mason is geared to helping customers manage their assets.

According to Mason, the following factors were considered in their decision to go public. They are in a very volatile business and the introduction of new products can hurt the industry. The CMA basically changed the whole complexion of the industry. Another factor was the regulatory indecision in the securities industry and which new entities will enter the business and how they will enter it.

In Mason's opinion, banks have entered the securities business with no immediate plans whatsoever of making money. It's very difficult to compete in an environment when one of your major competitors is not trying to make money. Mason is also worried about the Comptroller of the Currency, the FDIC and the Federal Reserve, which he believes are protective of the banking industry. The regulators are changing the rules of the game all the time and it is hard to make decisions in that environment.

"Linking with Another Organization"
Piper (Piper, Jaffray & Hopwood)

According to Piper, his firm did not link with the Hartford Insurance Company to obtain either capital or distribution -- their motive in linking was to protect themselves and to be able to control their own destiny.

In order to understand their motive in linking with Hartford, Piper described his firm. They are a regional firm with about 45 offices; $43 million in capital; and between 500 and 600 registered representatives. Although their activities are focused in the Upper Midwest and Pacific Midwest, they are a full-line firm; they try to run their firm as if it were a partnership.

Piper related the history of the Hartford transaction. Bache was bought by Prudential in 1981, then there were purchases of Dean Witter and Shearson. Some regional firms sold out at very lucrative prices. They owned 62% of their firm in the ESOP and felt they might be a target for a takeover. In this environment, their goal was to preserve their independence. They decided that a minority investment at a good price with protective provisions was the only way to accomplish that goal.

"Merging"
Kittell (Dean Witter Reynolds)

Kittell indicated that he will discuss mergers as a third strategy of obtaining capital and distribution from the perspective of the acquisition by Sears of Dean Witter Reynolds. Four topics will be covered: Sears' strategic decision to enter the financial services industry; Dean Witter Reynolds's decision to merge with Sears; the impact of the merger; and conclusions resulting from experience over the past two years.

In terms of Sears' decision to enter financial services, Kittell indicated three factors led Sears to look for markets other than its traditional retail market. Sears saw significant long-term pressure on the consumer disposable income base; a significant shift in priority from goods to services; and retail floor space across the country growing at twice the rate of retail sales.

According to Kittell, Sears focused on financial services for a number of reasons. Sears saw an increased demand for consumer financial services, opportunity for an outsider in the deregulated financial services industry, and Sears already possessed significant strengths in financial services (insurance, consumer credit, commercial paper, real estate). Sears had great strengths as a retailer which could be transferred to financial services.

Kittell indicated that Dean Witter Reynolds also went through the evaluation of strategic alternatives and options. Merger was not a new idea to Dean Witter Reynolds, itself the result of 13 mergers dating back to 1929. Dean Witter was competing head-on with 5 or 6 firms. The decision to merge with Sears would dramatically alter the dimensions and pace of the game. Dean Witter Reynolds evaluated the decision to merge with Sears in terms of market timing, compatibility with Sears' strategic objectives, likelihood of success, Sears' philosophy about managing an acquired entity, the impact on holding and recruiting securities industry professionals. In January, 1982 Sears acquired Dean Witter Reynolds for $610 million.

The merger had a very significant impact on Dean Witter's organization structure and its management support systems. Dean Witter reorganized around four new business units -- individual services, capital markets, consumer banking, and international.

VIEWS ON THE PAST AND FUTURE

An introduction to this, the concluding part of the conference, was provided by Richard S. Pechter (Pershing-DLJ). He indicated that Al Gordon would provide a strategic overview of what has been discussed throughout the day and would discuss the practical aspects of running a business in the securities industry over an extended period of time. He has seen everything and is able to place today's challenges and opportunities in the framework of history. Edward I. O'Brien (SIA) would discuss the challenges currently facing the securities industry.

"The Securities Industry: Yesterday and Today"

Gordon (Kidder, Peabody)

Gordon indicated that unlike most of the firms with presentations at the conference, Kidder is different: they have no outside stockholders; they have not gone public or merged; they have acquired 5 or 6 firms at book value.

Concerning planning, Gordon believes that it must not lean too heavily on rationality; planning is particularly difficult in the securities industry because of the volatility in markets and regulations. Securities firms are intermediaries who raise funds from investors for corporate or government issuers. Market volatilty was illustrated by reference to fluctuations in NYSE volume from 1929 onwards, along with price fluctuations of the Dow Jones average in the 1920s and early 1930s. Gordon also indicated that planning is difficult in the securities industry because of frequent crises. Planning requires forecasts, and accurate forecasting is a formidable task in the securities industry. Gordon does not believe we are better at it today than 50 years ago.

"Challenges Facing the Securities Industry"
O'Brien (SIA)

O'Brien is optimistic about the future of the securities industry for two reasons. First, there is increasing sophistication by clients and a growing need for financial services and for basic financial advice. Second, the securities industry is very flexible and can adapt to change quickly.

Examining what consumers want will indicate something about the future, since consumers sooner or later get what they want in our economic system. According to a Fortune magazine survey of consumer attitudes, 71% of those surveyed would not pay a premium for the convenience of one-stop financial shopping. The choice of financial service provider was made on the basis of grossly inadequate information about the services provided by financial institutions.

The industry's flexibility and entrepreneurial drive also provides for optimism about its future. The industry has been able to create and deliver many new products and services when needed, especially in the last 8-9 years. It has been able to attract talented new people. Finally, the industry has been able to greatly strengthen its capital base. Because the industry has been so creative and flexible in responding to opportunities in the marketplace in the past, O'Brien believes there is reason to be optimistic about the future.

According to O'Brien, the most important asset of the securities industry, its greatest advantage over other industries, is excellent, highly motivated individuals who do not have to work under bureaucratic conditions.

Neil L. Shandalow
Research Economist

SECURITIES INDUSTRY STATISTICS

VOLUME

	December 1983	YEAR-TO-DATE 1983	December 1982	YEAR-TO-DATE 1982	% CHG. Y-T-D 1983 - 1982
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)	88.0	85.4	76.5	64.9	31.6%
AMEX (MILS.)	6.9	8.2	7.5	5.3	54.7
NASDAQ (MILS.)	63.2	62.8	48.6	33.3	88.6
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	63,770	765,276	55,497	488,398	56.7%
AMEX (MILS.)	1,993	30,136	2,109	16,485	82.8
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	6,517	87,854	6,284	61,850	42.0
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	14,082	168,303	15,993	149,413	12.6
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	49.9	45.6	40.4	40.8	--
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	7,664	77,172	7,158	75,722	1.9
AMEX OPTIONS	3,021	34,198	3,734	38,767	(11.8)
COMMODITY	9,926	139,920	9,310	112,396	24.5

YIELDS

(MONTHLY AVERAGES)

	December 1983	December 1982	Basis Point Change
BOND BUYER INDEX (20 BOND)	9.89	9.96	(7)
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	12.57	11.83	74
Baa CORPORATE	13.75	14.14	(39)
RATIO Aaa CORPS. TO Baa CORPS.	0.91	0.84	--
MUNICIPAL BOND YIELDS (MOODY'S)	9.34	9.34	0

PRICES

(END OF MONTH)

	December 1983	December 1982	% Change Dec. 1983-Dec. 1982
DOW JONES INDUSTRIALS	1,258.64	1,046.54	20.3
STANDARD & POOR'S 500	164.93	140.64	17.3
NYSE COMPOSITE	95.18	81.03	17.5
AMEX MARKET VALUE INDEX	223.01	169.39	31.7
VALUE LINE COMPOSITE	194.35	158.94	22.3
NASDAQ COMPOSITE	278.60	232.41	19.9

MUTUAL FUNDS
(DOLLARS IN MILLIONS)

	December 1983	Year to Date 1983	December 1982	Year to Date 1982	% Change y-t-d 1982 - 1983
NET SALES*	1,350.0	18,162.9	768.1	5,164.3	251.7
NET PURCHASE OF COMMON STOCK*	751.1	12,651.9	65.5	1,278.6	889.5
NET PURCHASE OF OTHER SECURITIES*	498.2	2,613.0	541.2	2,838.5	(7.9)
MUTUAL FUND CASH POSITION	8.8	-	8.6	-	-

*EXCLUDES MONEY MARKET, MUNICIPAL BOND AND OPTION FUNDS

MARGIN DEBT

	December 1983	December 1982	% Change Dec. 83-Dec. 82
MARGIN DEBT OUTSTANDING ($MILS)	22,720	12,980	75.0
NET CHANGE IN MARGIN DEBT ($MILS)	9,740	(1,170)	-
% OF ACCOUNTS WITH EQUITY UNDER 40%	10	9	-

UNDERWRITING
(DOLLARS IN MILLIONS)

	December 1983	Year to Date 1983	December 1982	Year to Date 1982	% Change Dec.-Dec.	% Change 1983 - 1982
CORPORATE FINANCING (Gross New Issues)						
Total	5,905	99,533	10,179	78,987	(42.0)	26.0
Negotiated						
Common Stock	2,281	38,653	3,224	16,492	(29.3)	134.4
# Of Common Stock Issues	135	1,566	106	680	27.4	130.3
Preferred Stock	318	8,656	487	5,298	(34.7)	63.4
# Of Preferred Stock Issues	8	130	15	96	(46.7)	35.4
Corporate Debt	3,306	52,223	6,468	57,195	(48.9)	(8.7)
# Of Corporate Debt Issues	37	606	61	642	(39.3)	(5.6)
MUNICIPAL FINANCING* (Gross New Issues)						
Total	9,461	116,969	11,068	117,793	(14.6)	(0.7)
Notes	1,923	35,759	2,890	42,916	(33.5)	(16.7)
Bonds	7,538	81,210	8,178	74,877	(7.8)	8.5
# of Bond Issues	478	5,750	549	5,561	(12.9)	3.4
Negotiated Bonds	6,316	59,652	6,265	50,768	0.8	17.5
Revenue Bonds	6,770	58,780	6,407	51,810	5.7	13.5

FINANCIAL DATA FOR NYSE FIRMS DOING A PUBLIC BUSINESS
(MILLIONS OF DOLLARS)

	Third Quarter 1983	Yr.-to-Date 1983	Third Quarter 1982	Yr.-to-Date 1982	% Change 3rd Q.1983 3rd Q.1982	% Change Yr.-to-Date 1983-1982
REVENUE						
SECURITIES COMMISSION INCOME	1,977	6,480	1,479	3,751	33.7%	72.6%
REALIZED AND UNREALIZED GAIN OR LOSS IN TRADING AND INVESTMENT	1,707	5,913	1,786	3,656	(4.4)	61.7
PROFIT OR LOSS FROM UNDERWRITING AND SELLING GROUPS	872	2,718	595	1,391	46.6	95.4
TOTAL REVENUE	7,136	22,298	5,903	15,391	20.9	44.9
TOTAL EXPENSES	6,399	18,804	4,933	13,960	29.7	34.7
NET INCOME BEFORE TAXES	737	3,494	970	1,431	(24.0)	144.2
PERCENT OF FIRMS SHOWING LOSS	24.3%	--	16.0%	--	--	--

RECENT INTERESTING READING AND STATISTICAL MATERIAL

ITEM	DESCRIPTION	SOURCE
SIA Position Paper on Preservation of Access by U.S. to Foreign Capital	Paper analyzes the three current viable means of preserving access to foreign capital: Netherlands Antilles Treaty, Chafee-Bentsen/ Gibbons-Conable Bills, and the Barnard Bill. SIA strongly supports Chafee-Bentsen/Gibbons-Conable bills because of the resulting broader, free market, long term consequences. However, to the extent such legislation cannot be achieved, a narrower approach as incorporated in Barnard's bill is supported.	Research Department SIA
"Window Shopping With Shelfs" "A Green Light for Shelfs, But With If Clauses"	Rule 415 deals peaked early in 1983, with shelf users taking advantage of market windows. These convenience shelfs lacked the characteristics of the real thing and exaggerated the volume numbers for 1983 shelfs. If the new SEC provision intended to prevent convenience shelfs is heeded, 1984 shelfs may be near to nothing. Second article summarizes due diligence guidelines of SEC for shelfs.	Investment Dealers' Digest 1/10/84
"Deals of the Year"	Chart depicting 50 biggest deals, M&A's and securities offerings, in 1983, with data on financial intermediary handling the deal and fee. 1983's 50 biggest deals totaled $38.4 billion, and total financial intermediary fees topped $260 million.	Fortune 1/23/84
"Background for Those Record Deficits"	Concise chart and tables tracing Federal surplus and deficit from 1929 through 1982 by Administration and as % of GNP, with select summary points. While neither political party has had any particular monopoly on budget balancing, the 1982 deficit-to-GNP ratio, 4.8%, surpasses both the previous peacetime high deficit (4.5% in 1975) and the 4.4% ratios set in the Great Depression.	Tax Notes 1/2/84

ITEM	DESCRIPTION	SOURCE
"How the institutions rank the top brokerage firms"	Ninth annual survey of largest institutional investors' ranking of top ten brokerage firms in terms of: 1. overall best service, 2. most useful research, 3. accessibility of key personnel, 4. order execution and 5. handling of block positions.	Financial World 1/11/84
"Inside the Goldman Sachs culture"	Article attempts via firm interviews to identify factors which make up the "GS culture", such as teamwork, homegrown talent, and decentralized management. Concludes that driving force of GS is in the sense of common cause in its people, on which future success will depend.	Institutional Investor January, 1984
Marketing Financial Services (by Robert Perez)	As a result of increased competition following financial services industry deregulation, and reduction of barriers between segments of the industry, firms in the industry have increasingly adopted marketing activities. This book examines the marketing concepts/methods/activities (product design, price, place, promotion) used by the major segments of the industry: commercial banks, savings banks, life and casualty insurance companies, mutual funds, securities firms and pension funds. Concludes with a discussion of future marketing trends in the financial services industry.	Praeger Publishers 521 Fifth Avenue New York, NY 10175
The Financial Health of Canadian Corporations	A 36-page research report determining that Canadian corporations are excessively debt financed. Predicts $40 billion of new equity is needed in 1983 and 1984 combined to reach reasonable targets for debt/equity ratios and growth in business assets. Offers suggestions on creating a public policy environment to sustain record levels of new share capital raised in 1983.	The Toronto Stock Exchange January, 1984

Securities Industry
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AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
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SOME OBSERVATIONS ON INDUSTRY PROFITABILITY

(Remarks by Edward I. O'Brien at the
SIA Spring Meeting, May 7, 1984)

Good morning. We just heard Dick Jenrette give us an important overview of industry developments. In my remarks this morning, I thought we'd take a different look at things. I felt it would be a good idea to review the industry's performance in 1983 -- and in the first quarter of this year -- and see just where the industry stands. I think you may be surprised that the numbers are a lot less bleak than the first quarter earning reports of some of the major firms would indicate.

In order to get a perspective on things, let's look at four major areas:

- Market activity
- Revenue and expenses
- After-tax return on equity
- Capital.

Starting with market activity is useful, because however much we have diversified as an industry, the lion's share of our revenue and earnings is related in one way or another ~~to mark~~et volume.

In this area, 1983 was spectacular. Taken as a whole, share volume on the Big Board, Amex, regional exchanges and OTC market increased by an impressive 50 percent. This is a considerably bigger jump than in recent years:

* On NASDAQ alone, volume soared by 89 percent.

* Volume was up 56 percent on the Amex,

* 40 percent on the regional exchanges

* And 31 percent on the Big Board.

The performance of these market centers underscores the solid retail nature of last year's volume. Riding the crest of the volume increase were the popular stock price indices. At year-end 1983,

* The Amex market value index was up 40 percent,

* The Dow Jones Industrials and the NASDAQ Composite Index were up 20 percent,

* And the Standard & Poor's 500 was up 17 percent, as was the NYSE Composite Index.

The buoyant markets of last year contributed to a busy underwriting calendar. Public corporate underwritings reached nearly $100 billion -- up 26 percent from the $79 billion underwritten in 1982. The underwriting of common stock issues alone rose by more than $20 billion, which more than doubled the 1982 figure.

What's particularly exciting about the underwriting area is that --

Initial public offerings increased fourfold in terms of number of shares

and nearly ninefold in terms of share value.

In dollar terms, IPOs went from $1.5 billion in 1982 to an incredible $12.6 billion in 1983.

Meanwhile, in the debt market, offerings of corporate debt declined about 9 percent, from $57 billion to $52 billion.

There was good news on the mutual fund front, as well.

* Net sales of open-end equity funds increased to $22 billion from $5.6 billion in 1982.

* The assets of the funds rose to $113 billion from $77 billion,

* And the actual number of funds grew to 653 from 539.

So our friends over at the Investment Company Institute should have some good news to report in a few weeks at their annual meeting.

Chart 1

New Derivative Products - 1982 and 1983

Date	Product	Type	Exchange	1983 Volume (thousands of contracts)
1982				
2/24	Value Line	Future	KCBT	725.0
4/21	S&P 500	Future	CME	8101.7
5/6	NYSE Composite	Future	NYFE	3506.4
1983				
1/28	S&P 500	Opt. on Future	CME	281.1
1/28	NYSE Composite	Opt. on Future	NYFE	286.2
3/11	S&P 100	Option	CBOE	10595.6
4/29	Major Mkt.	Option	AMEX	2034.5
7/1	S&P 500	Option	CBOE	14.1
7/8	Mkt. Value	Future	AMEX	78.3
7/14	S&P 100	Future	CME	390.9
7/29	Mini Value Line	Future	KCBT	25.1
8/26	Computer Tech.	Option	AMEX	526.0
9/9	Oil & Gas	Option	AMEX	56.3
9/19	S&P Int. Oil	Option	CBOE	4.8
9/23	NYSE Composite	Option	NYFE	628.7
9/28	S&P Composite	Option	CBOE	48.0

To return to our own backyard, 1983 saw the introduction of 13 new derivative products, as compared with only three such products in 1982. These products were of three types --

- Options on broad or narrow-based stock indices,
- Futures on stock indices,
- And options on broad-based index futures.

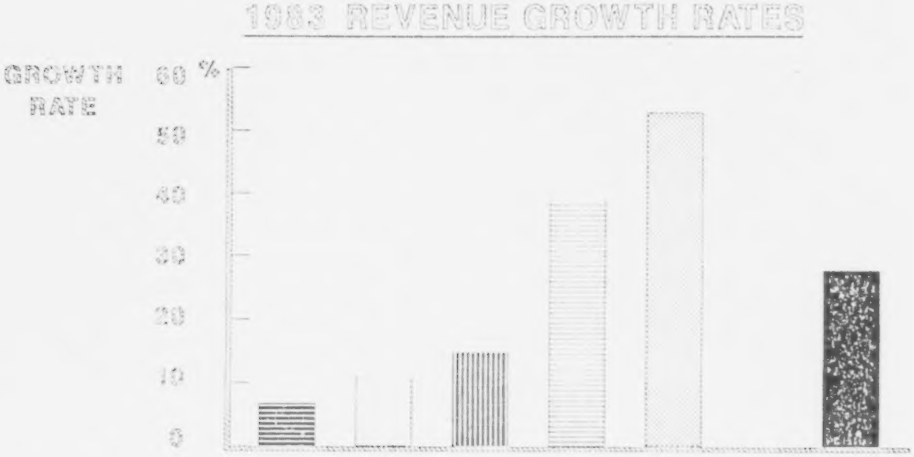
The rapid expansion and proliferation of these products has led to confusion among firm managements, the exchanges, the account executives and -- most importantly -- among our customers.

In an attempt to address the challenges of these new products, SIA created a committee to work with the exchanges, firms and SEC. The committee is under the very able direction of Bob Shapiro, and we'll be hearing about its work in coming months.

Well now, let's get to the bottom line. Where did all the volume and underwriting activity and new products take us in 1983?

On the revenue side, they took us quite far. Gross revenues increased by $6.4 billion to nearly $30 billion in 1983 -- an increase of 28 percent. It's interesting to note that the fastest growing segments of the revenue pie were in the core areas of our business -- commissions and underwriting revenue.

Chart 2



REVENUE ITEMS	GROWTH RATE
▤ MARGIN INTEREST	7 %
☐ OTHER RELATED	11
▥ TRADING	15
▤ COMMISSIONS	39
▨ UNDERWRITING	53
■ TOTAL REVENUE	28 %

Commission revenue increased by 39 percent, or $2.4 billion, while underwriting revenue was up 53 percent, or $1.2 billion.

Some of the more publicized areas of our business showed improved performance as well, but not to the degree of commissions and underwriting.

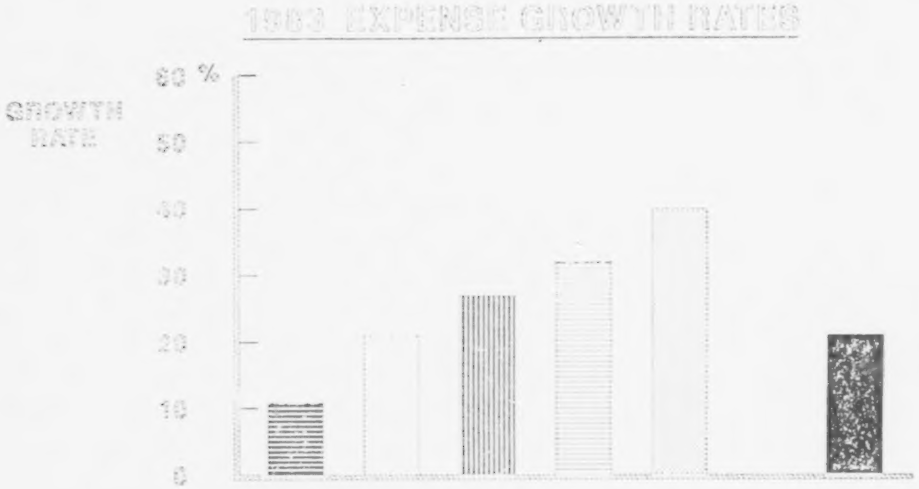
* Trading profits, for instance, rose by $907 million, or 15 percent.

* Commissions from mutual fund sales rose $665 million, or 232 percent.

* And the so-called other related revenue -- which is largely the repo and mergers and acquisitions business -- rose by $450 million, or 11 percent.

While the good news for 1983 was that revenues were strong -- up 28 percent -- the bad news is that expenses also increased -- by the same 28 percent. By way of contrast, in 1982 revenues increased 17 percent, while expenses were up only 14 percent.

Chart 3



1983 EXPENSE GROWTH RATES

EXPENSE ITEMS	GROWTH RATE
▤ INTEREST	11 %
☐ COMMUNICATIONS	21
▥ OTHER	27
▤ ADMINISTRATIVE & CLERICAL EMPLOYEE EXPENSES	32
☐ REGISTERED REP. COMPENSATION	40
■ TOTAL EXPENSES	28 %

In 1983, expenses increased by $5.6 billion to $25.7 billion. Four expense categories accounted for nearly 70 percent of total costs last year. These were:

* RR compensation, which grew by 40 percent, or $1.7 billion;

* Clerical and administrative expenses, which increased by 32 percent, or $1.2 billion;

* Interest expense, which grew by 11 percent or $587 million;

* and expenses in the so-called "other" category, which rose by 27 percent or $481 million.

As you can see, the fastest growing expense item last year was RR compensation -- up by 40 percent. That increase can be explained three ways.

* First, RRs were more productive last year and were compensated accordingly.

* Second, payout percentages increased.

* And finally, more RRs were employed by the industry.

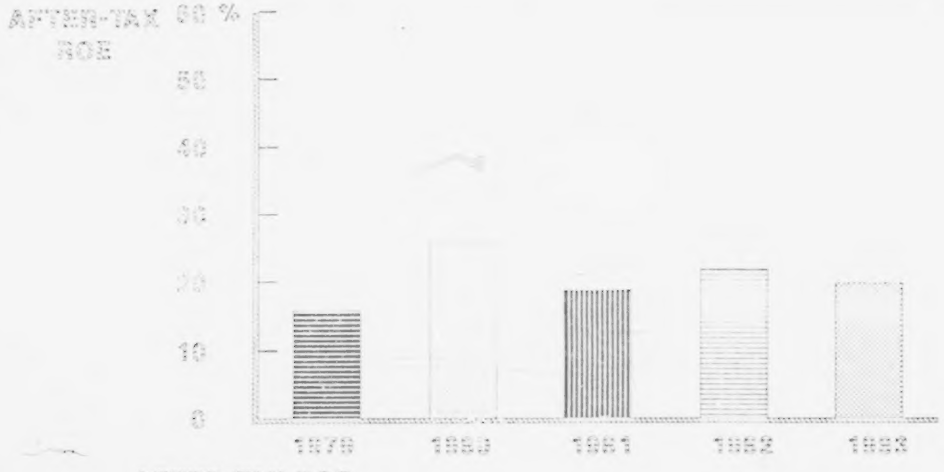
The largest expense category last year -- interest expense -- actually rose the least of all cost categories for the year as a whole. But the sharp spurt in interest expense in the third and fourth quarters of last year was the major factor in the sharp plunge in industry profitability in the second half of 1983. During the second half, in fact, interest expense rose at an annual rate of 90 percent!

In other words, despite all the efforts made at cutting controllable costs such as administrative and clerical expenses, the uncontrollable cost of interest expenses has a much more profound impact on our industry's bottom line. But in a way, this shouldn't surprise us. Interest income and expense have always played an important role in the industry.

Now let's look at that bottom line. The net result of the upward trend in revenues and expenses was that the industry's pre-tax net income rose 26 percent last year, to $3.8 billion from $3 billion.

Chart 4

SECURITIES INDUSTRY AFTER-TAX RETURN-ON-EQUITY, 1979-1983



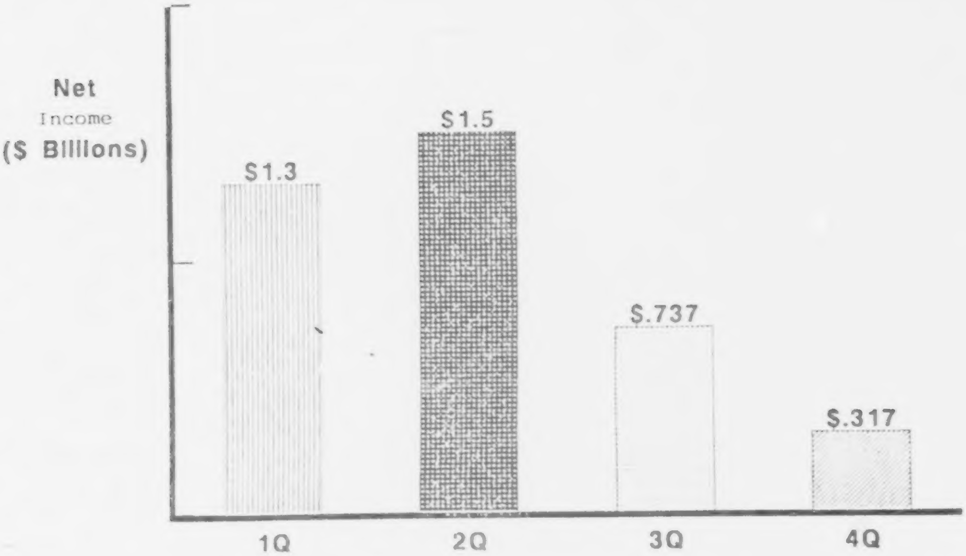
AFTER-TAX ROE	
1979	16%
1980	26
1981	19
1982	22
1983	20

The industry's after-tax return on equity declined, however, largely because the industry's capital base was larger for the year. Capital jumped $3.4 billion to $14 billion -- which drove the after-tax return on equity down to 19.8 percent from 22 percent in 1982. This 19.8 percent return on equity, however, was very close to the figures for 1981 and 1982, and considerably above the R-O-E for the 1973 to 1979 period.

Clearly, the industry's profitability would have been higher if costs had not increased as they did. Let's look at profitability on a quarterly basis.

Chart 5

1983 QUARTERLY NET INCOME

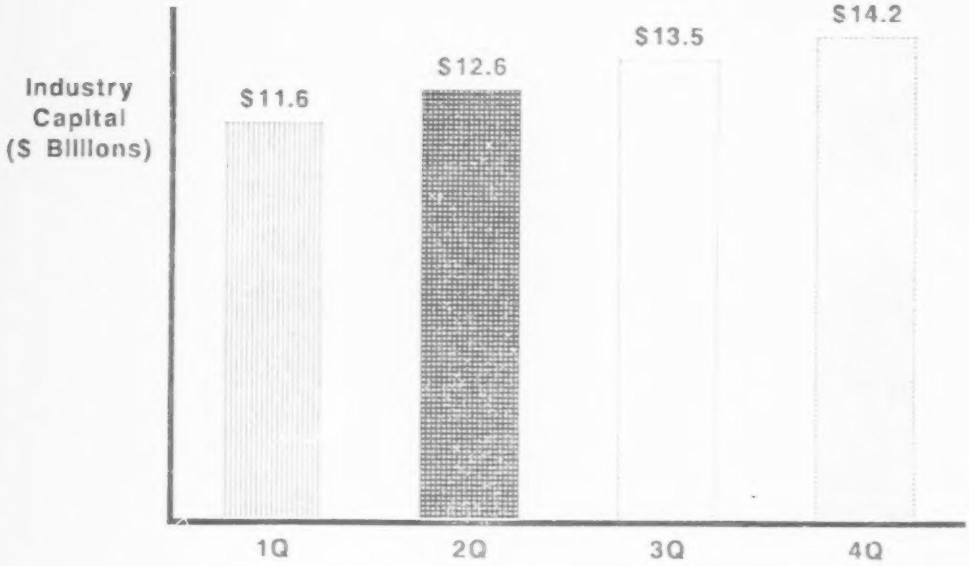


You can see that the industry's profits jumped from the first to the second quarter and then slid. Net income was

- $1.3 billion in the first quarter,
- $1.5 billion in the second quarter,
- about three-quarters of a billion in the third quarter,
- and then only $317 million in the final quarter.

Chart 6

1983 QUARTERLY INDUSTRY CAPITAL



While profitability was sliding, capital was increasing. And that itself is a salutory sign for the long-run outlook for the industry. Because capital, after all, is an unassailable vote of confidence in our business.

If you look at the bar graph representing 1983 on the right hand side of the slide, you can see that R-O-E started off with a bang in the first half, and then fell --

* From 30 percent for the first quarter and 31 percent for the second,

* To 15 percent for the third

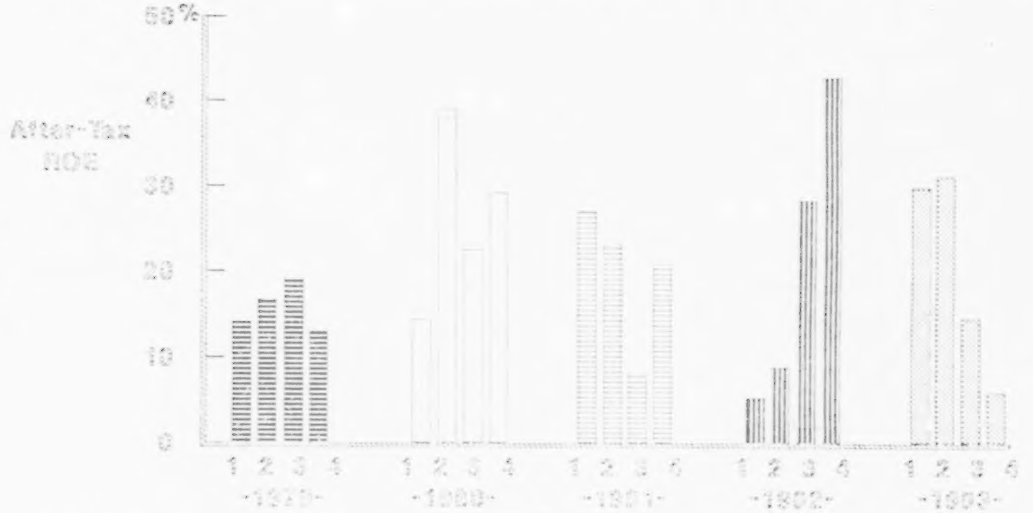
* And 6 percent for the fourth quarter.

Clearly, as you can see from this slide's five year analysis of R-O-E , our industry's profitability is extremely volatile. Nothing new there, I might add!!

Predicting profitability from quarter to quarter -- especially using the past as a guideline -- is difficult at best and probably futile. Perhaps this reinforces what we've been saying for years -- that this business of ours is grounded on the unpredictable with all its attendant risks.

Chart 7

SECURITIES INDUSTRY QUARTERLY ANNUALIZED AFTER-TAX RETURN-ON-EQUITY, 1979-1983



	1979		1980		1981		1982		1983
1	14.2%	1	15.5%	1	27.1%	1	5.5%	1	30.0%
2	16.8	2	39.1	2	23.2	2	9.1	2	31.0
3	19.3	3	22.5	3	8.1	3	28.5	3	14.7
4	13.1	4	29.3	4	20.9	4	41.3	4	6.0

Given this volatility, it's useful to analyze which revenue and expense items are most responsible for the swings.

In the third quarter of last year, for example, total revenue dropped by $831 million. Three items accounted for nearly all the drop --

* Commission revenues, which fell by $409 million;

* Commissions from mutual fund sales, which were down $267 million;

* And underwriting revenue, which fell by $130 million.

On the expense side, costs declined by only $103 million. While lower expenses for RR compensation, floor brokerage and administrative and clerical salaries helped lower costs substantially, these were offset by higher costs for communications, rent, EDP equipment, promotional expenses and -- most importantly -- the surge in interest expense by $304 million.

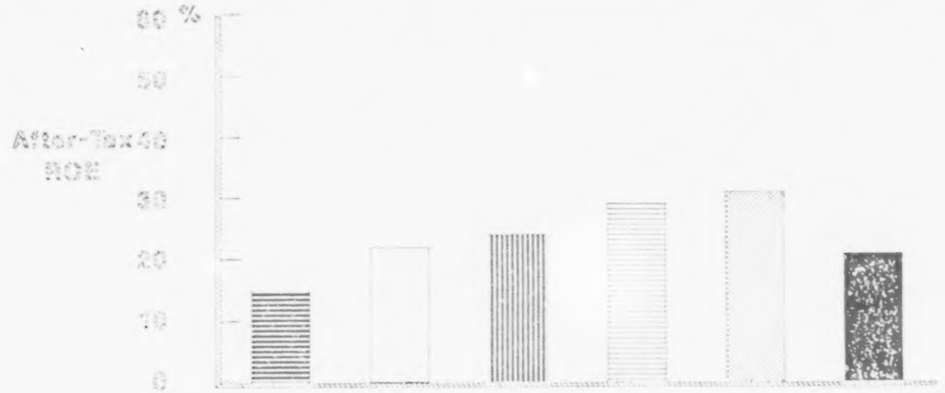
I should add that our business is becoming more and more high-tech. And we're doing that in order to better serve our customers and to provide real value added.

So for the near future, EDP costs will continue to rise regardless of revenues.

Let's look at last year again and see how the industry did on a category-by-category basis.

Chart 8

AFTER-TAX RETURN-ON-EQUITY BY FIRM CATEGORY, 1983



	FIRM CATEGORY	1983 AFTER-TAX ROE	1982 AFTER-TAX ROE
▤	NATIONAL FULL-LINE	15 %	16 %
☐	REGIONALS	22	20
▥	LARGE INVESTMENT BANKING	24	30
▤	DISCOUNTERS	29	25
☐	LARGE NEW YORK CITY	31	22
■	SECURITIES INDUSTRY	20 %	22 %

As you can see, the performance of the industry as a whole in 1983 was better than you might have believed.

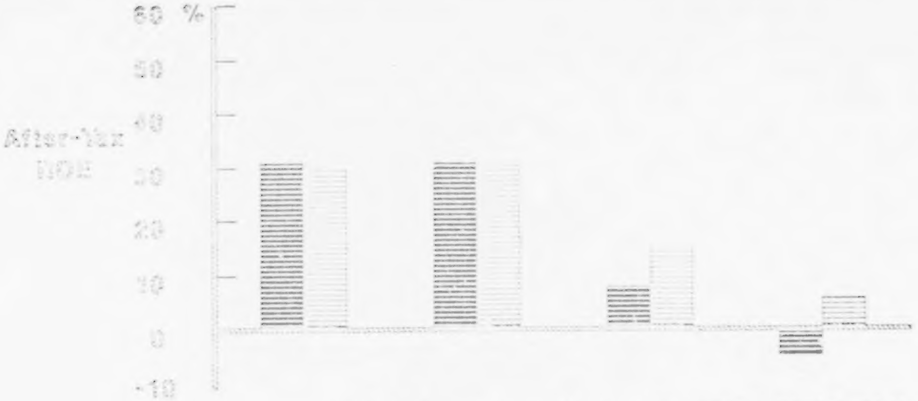
One reason for the misconception about industry profitability is that the figures appearing in the press are generally those for the publicly-owned firms -- most of which are national full-line firms. These, as you can see, earned an after-tax R-O-E of 15 percent in 1983 -- substantially below the 20 percent return of the industry as a whole.

I should point out, however, that the national full-line firms are dramatically reducing their costs. And, like the auto makers, they should enjoy tremendous upside leverage when the environment for securities firms improves.

Let's look at each category's performance on a quarter-by-quarter basis.

Chart 9

NATIONAL FULL-LINE VERSUS INDUSTRY 1983 QUARTERLY ANNUALIZED AFTER-TAX RETURN-ON-EQUITY



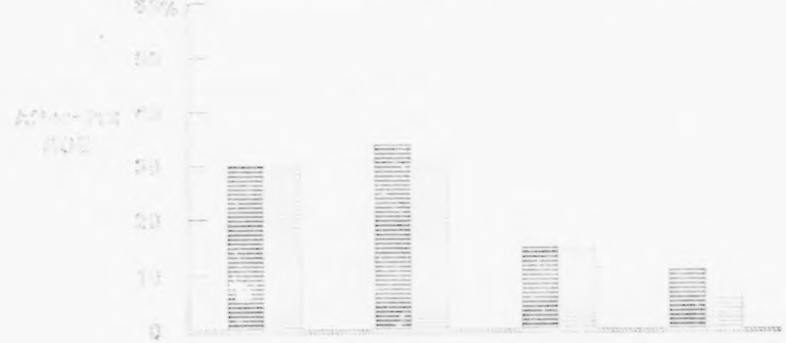
1983 QUARTERLY ANNUALIZED AFTER-TAX ROE

QUARTER	NATIONAL FULL-LINE	INDUSTRY
1	31 %	30 %
2	31	31
3	8	15
4	(5)	6
	15 %	20 %

Again, we see that national full-line firms did not do as well as the industry as a whole in any quarter, with the exception of the second quarter.

Chart 10

REGIONALS VERSUS INDUSTRY 1983 QUARTERLY ANNUALIZED AFTER-TAX RETURN-ON-EQUITY



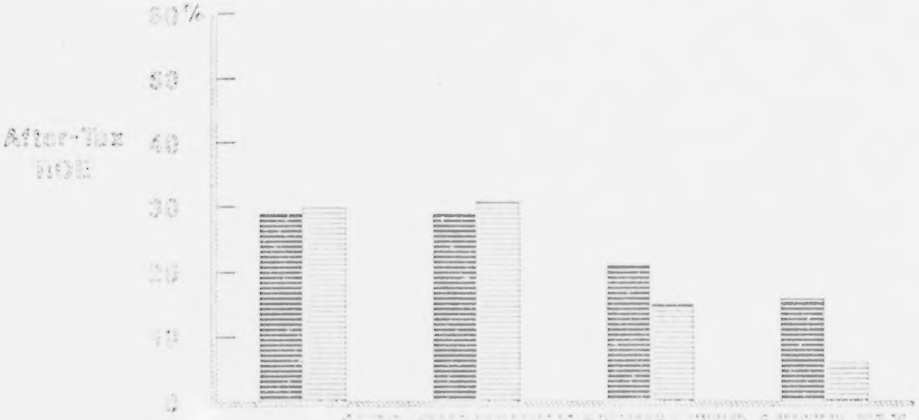
1983 QUARTERLY ANNUALIZED AFTER-TAX ROE

QUARTER	REGIONALS	INDUSTRY
1	30 %	30 %
2	34	31
3	15	15
4	11	6
	22 %	20 %

Regionals did slightly better than the industry, as did large investment banks.

Chart 11

LARGE INVESTMENT BANKS VERSUS INDUSTRY 1983
QUARTERLY ANNUALIZED AFTER-TAX RETURN-ON-EQUITY



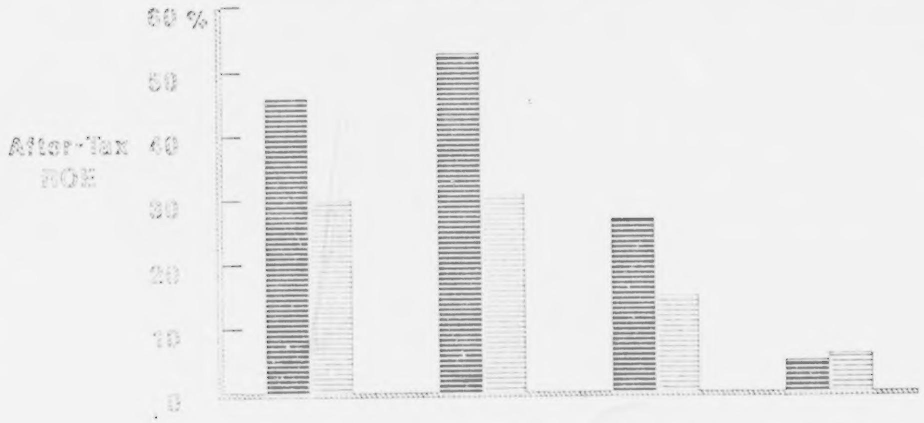
1983 QUARTERLY ANNUALIZED AFTER-TAX ROE

QUARTER	LARGE INVESTMENT BANKS	INDUSTRY
1	29 %	30 %
2	29	31
3	21	15
4	16	6
	24 %	20 %

On a quarterly basis, they slightly underperformed the industry for the first two quarters of the year and then considerably outperformed the industry for the second two quarters of 1983.

Chart 12

DISCOUNTERS VERSUS INDUSTRY 1983 QUARTERLY ANNUALIZED AFTER-TAX RETURN-ON-EQUITY



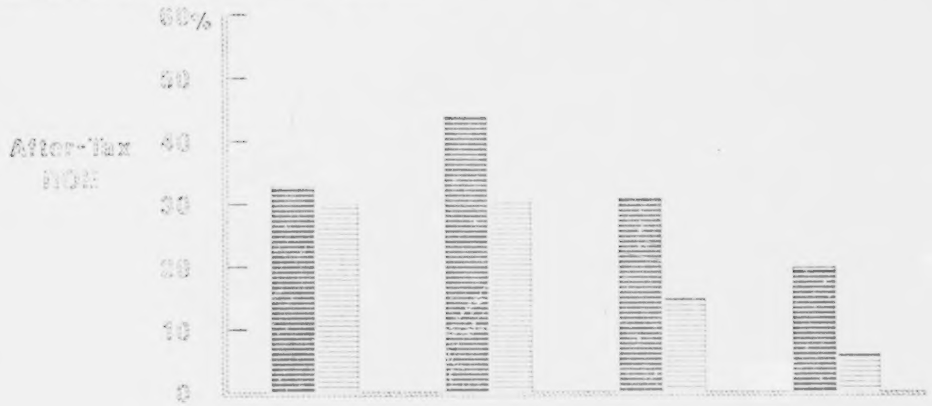
1983 QUARTERLY ANNUALIZED AFTER-TAX ROE

QUARTER	DISCOUNTERS	INDUSTRY
1	46 %	30 %
2	53	31
3	27	15
4	5	6
	29 %	20 %

Discounters outperformed the industry by a considerable margin, and did so for every quarter of 1983, except the fourth quarter, when they did slightly worse than the industry.

Chart 13

LARGE NEW YORK CITY VERSUS INDUSTRY 1983
QUARTERLY ANNUALIZED AFTER-TAX RETURN-ON-EQUITY



1983 QUARTERLY ANNUALIZED AFTER-TAX ROE

QUARTER	NEW YORK CITY	INDUSTRY
1	33 %	30 %
2	44	31
3	31	15
4	20	6
	31 %	20 %

The one category that outperformed the industry throughout the year was the large New York City firms.

Before I leave the area of profitability, one point I'd like to make concerns our industry vis-a-vis American industry as a whole. Despite its lower profitability in the fourth quarter of 1983, our industry was among the most profitable in the nation for the year as a whole.

Compare our 20 percent R-O-E to the 16.6 percent return of the computer industry, or the 16.7 percent return of the auto industry, which enjoyed a spectacular year. Of course, we should not be satisfied with a return typical of American industry as a whole.

Most analysts believe the securities industry merits a 3 to 5 percentage point R-O-E premium due to the volatility and riskiness of our business. But that said, 1983 was still a very good year for the securities industry.

Now, what of 1984? The economic climate, at least in the first quarter, has not been conducive to profitability. The trend in interest rates was upward. The yield on a 3-month Treasury bill was 9.72 percent at the end of the first quarter of 1984 compared to 8.96 percent at year-end 1983.

On the inflation front, things are much better. The annual rate of inflation is little changed from last year, remaining below the 5 percent level.

Of course, the outlook for inflation and interest rates is affected by the outlook on the deficit. The good news is that a number of legislative proposals have been advanced to reduce the deficit. But the bad news is that the Democratic and Republican plans differ substantially and there is little agreement on expenditure reductions. Assuming the smaller of the expenditure cuts, the package would be worth $15 billion in fiscal 1985, $40 billion in 1986, and $60 billion in 1987. Thus, the budget outlook remains bleak.

I should mention here that SIA is working actively on a number of tax proposals and is monitoring pending legislation so that the burden of any new tax increases will not scuttle the hard-won, important, and effective gains we have made in providing incentives for saving and investing.

Looking at our industry in the first quarter, we can see that all major common stock price indices were down for the period.

* The Dow Jones Industrials were off 7.5 percent,
* The N-Y-S-E Composite was off almost 4 percent,
* The S&P 500 was off by almost 5 percent,
* The Amex Composite was down slightly more than 5 percent,
* And the NASDAQ Composite was off by 10 percent.

Surprisingly, share volume on the Big Board rose 10 percent in the first quarter, reflecting what we believe is a shift to a more institutional market. On the Amex, volume fell by nearly 10 percent and on NASDAQ, volume was off by 1 percent.

In underwriting, the story was disappointing. While corporate bond underwriting rose 50 percent to $14 billion, the gain was measured against a poor fourth quarter. Meanwhile, common stock underwriting fell to $2.3 billion. Can anyone doubt that under the right market conditions this pullback can be reversed?

Based on SIA's newly automated Securities Industry Data Base, the profit outlook for the first quarter is similar to the fourth quarter of last year. SIA estimates that after-tax R-O-E for the first quarter will be in the range of 5-to-8 percent for the industry as a whole. In fact, this range is substantiated by the most recent "SIA Profitability Report," which showed an after-tax R-O-E of about 6 percent for the participating member firm subscribers.

And now, for the rest of the year.

As we've seen, the performance of our industry is related closely to the direction of interest rates. And predicting the course of interest rates is a task I'd rather leave to Fed watchers, economists and psychics. These sages, however, often are wide of the mark, since their pessimism overcomes their better judgment. Overall, though, I think you'd agree with me that there's a much higher degree of skittishness in the air than there has been in recent years.

For instance, when interest rates seem about to drop a few basis points, the market rallies. When there's a hint that interest rates are about to go up, the market falls. So interest rates will play a major role in the performance of the industry for the remainder of the year, as they have for the past several years.

Also playing a role will be the election. Whether President Reagan or a Democrat is elected, the President sworn in next January will face a mounting deficit that must be slashed. And that means either reduced spending, higher taxes, or -- most probably -- both.

So even assuming a scenario for the second half of the year that is favorable, it appears that 1984 will not be one of the strongest years for the securities industry.

That said, however, our industry's profitability has been far above that of American industry as a whole -- and even higher than many of the so-called glamour industries in recent years. Moreover, activity and recent price trends indicate that the second quarter will provide a friendlier environment for us than the disappointing first quarter.

Because of these short-term factors -- and because of several long-term factors as well -- I believe our industry will continue to attract top people, continue to attract capital, and continue to be seen -- for better or worse -- as an inviting target for acquisition minded outsiders.

Thank you.

Edward I. O'Brien
President

SECURITIES INDUSTRY STATISTICS

VOLUME

	MARCH 1984	YEAR-TO-DATE 1984	MARCH 1983	YEAR-TO-DATE 1983	% CHG. Y-T-D 1984 - 1983
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	84.3	95.3	82.7	85.4	11.6
AMEX (MILS.)*	5.3	6.3	7.7	8.4	(25.0)
NASDAQ (MILS.)*	57.6	61.2	56.3	58.2	5.2
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	63,905	209,004	64,972	181,681	15.0
AMEX (MILS.)	1,860	5,820	2,588	7,446	(21.8)
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	7,242	23,390	8,234	22,489	4.0
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	13,729	41,375	17,272	46,771	(11.5)
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	49.6	49.3	44.4	43.3	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	5,075	17,856	5,444	17,270	3.4
AMEX OPTIONS	3,591	9,971	3,001	8,925	11.7
COMMODITY	13,958	37,595	11,723	33,976	10.7

* *MONTHLY AVERAGE*

YIELDS

(MONTHLY AVERAGES)

	MARCH 1984	MARCH 1983	Basis Point Change March'84-March'83
BOND BUYER INDEX (20 BOND)	9.94	9.20	74
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	12.57	11.73	84
Baa CORPORATE	13.99	13.61	38
RATIO Aaa CORPS. TO Baa CORPS.	0.90	0.86	---
MUNICIPAL BOND YIELDS (MOODY'S)	9.41	8.42	99

PRICES

(END OF MONTH)

	MARCH 1984	MARCH 1983	% Change March'84-March'83
DOW JONES INDUSTRIALS	1164.9	1130.3	3.1
STANDARD & POOR'S 500	157.06	152.96	2.7
NYSE COMPOSITE	91.67	88.03	4.1
AMEX MARKET VALUE INDEX	422.68*	389.08*	8.6
VALUE LINE COMPOSITE	182.19	179.25	1.6
NASDAQ COMPOSITE	250.78	270.80	(7.4)

* Adjusted for 2-1 split on 7/5/83.

MUTUAL FUNDS
(DOLLARS IN MILLIONS)

	MARCH 1984	Yr.-to-Date 1984	MARCH 1983	Yr.-to-Date 1983	% Change Y-T-D 1984-1983
NET SALES*	1875.6	5072.3	1824.3	4291.4	18.2
NET PURCHASE OF COMMON STOCK*	482.7	1259.4	1239.3	2682.0	(53.0)
NET PURCHASE OF OTHER SECURITIES*	376.2	1026.0	337.3	281.2	264.9
MUTUAL FUND CASH POSITION	11.4	----	11.1	-----	------

*EXCLUDES MONEY MARKET, MUNICIPAL
BOND AND OPTION FUNDS

MARGIN DEBT

	MARCH 1984	MARCH 1983	% Change Mar.'84-Mar.'83
MARGIN DEBT OUTSTANDING ($MILS)	22,460	14,170	58.5
NET CHANGE IN MARGIN DEBT ($MILS)	8,290	2,330	----
% OF ACCOUNTS WITH EQUITY UNDER 40%	11.0	9.0	----

UNDERWRITING
(DOLLARS IN MILLIONS)

	MARCH 1984	Year-to-Date 1984	MARCH 1983	Year-to-Date 1983	% Change March-March	% Change 1984-1983
CORPORATE FINANCING (Gross New Issues)						
Total	4,227	17,627	12,795	28,042	(67.0)	(37.1)
Common Stock	707	2,344	5,876	9,908	(88.0)	(76.3)
# Of Common Stock Issues	64	217	137	286	(53.3)	(24.1)
Preferred Stock	288	1,051	908	3,761	(68.3)	(72.1)
# Of Preferred Stock Issues	6	17	14	49	(57.1)	(65.3)
Corporate Debt	3,232	14,032	6,011	14,373	(46.2)	(2.4)
# Of Corporate Debt Issues	37	157	58	171	(36.2)	(8.2)
MUNICIPAL FINANCING* (Gross New Issues)						
Total	8,421	22,632	10,132	24,215	(16.9)	(6.5)
Notes	3,393	8,138	2,282	6,976	48.7	16.7
Bonds	5,028	14,494	7,850	17,239	(36.0)	(16.0)
# of Bond Issues	376	890	570	885	(34.0)	0.56
Negotiated Bonds	3,119	10,193	4,520	11,936	(31.0)	(14.6)
Revenue Bonds	2,945	8,633	5,035	11,991	(41.5)	(28.0)

*Preliminary Figures

FINANCIAL DATA FOR NYSE FIRMS DOING A PUBLIC BUSINESS
(MILLIONS OF DOLLARS)

	FOURTH QUARTER 1983	Yr.-To-Date 1983	FOURTH QUARTER 1982	Yr.-To-Date 1982	% Change 4th Q.1983 4th Q.1982	% Change 1983 - 1982
REVENUE						
SECURITIES COMMISSION INCOME	1,868	8,326	2,270	5,972	(17.7)	39.4
REALIZED AND UNREALIZED GAIN OR LOSS IN TRADING AND INVESTMENT	1,660	7,572	2,397	6,532	(30.7)	15.9
PROFIT OR LOSS FROM UNDERWRITING AND SELLING GROUPS	812	3,537	929	2,316	(12.6)	52.7
TOTAL REVENUE	7,245	29,515	7,823	23,100	(7.4)	27.8
TOTAL EXPENSES	6,928	25,706	6,199	20,079	11.8	28.0
NET INCOME BEFORE TAXES	317	3,809	1,624	3,021	(80.5)	26.1
PERCENT OF FIRMS SHOWING LOSS	37.3	14.5	9.3	16.5	301.1	(12.1)

RECENT INTERESTING READING AND STATISTICAL MATERIAL

ITEM	DESCRIPTION	SOURCE
Transcript: SIA Trends Conference on Deregulation: Opportunities & Pitfalls	153-page transcript records varied perspectives on how the industry might cope with the inevitable trend toward deregulation. The alternative strategies under deregulation are explored, as well as the specific strategies employed by four different types of firms. In addition, strategies for obtaining capital and distribution are discussed. The keynote speaker, Charles L. Brown, gives an intriguing look at AT&T after divestiture.	SIA Research Department $25 Conference attendees $50 all others
SIA Statement before the House Ways and Means Committee on Tax Treatment of Interest Paid to Foreign Persons, 5/1/84	SIA believes the best way of preserving and broadening access for U.S. corporations to the Eurobond market is through enactment of the Gibbons-Conable bill. Testimony discusses the benefits of immediate repeal of the 30% withholding tax, including $150 million in tax revenue now paid to the Netherlands Antilles and the broadening of foreign investors' ability to purchase newly-offered debt securities of all U.S. borrowers.	SIA Research Department
Report on Human Resources Management Practices & Employee Benefits -- 1984	123-page companion survey to SIA annual salary surveys. Among the topics covered in the report are sources of employees, job evaluation and salary administration, vacation holiday and time-off practices, health and life insurance plans, and pension and profit-sharing benefits.	Madeleine L. Ritter SIA SIA Members $400 Others $550
Discount Brokerage of Securities: A Status Report	This report provides some statistical measures of discount brokerage activity, with comments on the adequacy of the data presented. The report also deals with factors influencing customer preference in choice of brokers, and includes comments from a variety of sources on the anticipated future of discount brokerage.	Congressional Research Service The Library of Congress Report #84-32 E 3/12/84

ITEM	DESCRIPTION	SOURCE
"Soft dollars: The boom in third-party research"	Extensive article on the boom in third-party research. Growing numbers of entrepreneurs are vying with traditional Wall Street producers for a slice of the commission pie. Some observers believe the success of these firms could lead to the eventual "unbundling" of the Street's own research products.	Institutional Investor 4/84
American Stock Exchange Annual Report 1983	The AMEX Market Value Index outperformed all other leading indices, setting new records 45 times during 1983 and closing the year up 31% from the previous year's close. Annual report details records set in 1983 and contains 10-year statistical summary of trading, financial data and options.	American Stock Exchange 85 Trinity Place N.Y., N.Y. 10006
Canadian Shareowners: Their Profile and Attitudes	Canadian Shareownership Survey shows that only 11% of adults own stock, compared with a 22% incidence of shareownership in the U.S. Report includes sections on profile of shareowners, reasons for investing, investment portfolio characteristics, shareowners' use of financial services and factors influencing investment decisions.	Toronto Stock Exchange Circulation Div.
Federal Reserve Bank of New York Annual Report 1983	Sixty-ninth annual report reviews major economic and financial developments, at home and abroad. While the economic recovery in 1983 exceeded most expectations, the financial markets remained concerned about the long-term outlook for inflation as the expansion continued against the backdrop of unprecedented projected budget deficits.	Public Information Federal Reserve Bank of New York 33 Liberty Street N.Y., N.Y. 10045

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A FLAT RATE TAX: PROS & CONS

HIGHLIGHTS

1. The flat rate income tax concept will receive a full hearing over the next year along with other tax alternatives to our current tax system. It is healthy for the capital markets and the securities industry to start thinking sooner rather than later about the implications.

2. In recent years, individuals' real after-tax purchasing power has declined as both the progressive income tax and inflation eroded increases in income. While inflation has subsided from the levels which spurred public protest against bracket creep in the 1970s, the growth of two-worker families is but one indication that bracket creep is not necessarily a thing of the past.

3. The obvious trade-off to any flat rate proposal is a substantial broadening of the tax base. Given concern over projected Federal deficits, the flat rate's potential for broadening the tax base and increasing revenues has taken on a new significance.

4. Some proposals built on the flat rate concept specifically address savings and investment, others do not. As the key to stimulating savings and investment is the after-tax return, proposals which sharply increase the effective tax rate on capital gains are disappointing.

5. Under a pure flat rate tax, there would be a reallocation of funds to lower risk investments until a new equilibrium is reached, given the same level of savings. However, we believe that, with marginal rates at 20% or less, there would be a move away from consumption toward savings.

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Introduction

The Economic Recovery Tax Act of 1981 (ERTA) contained some of the most sweeping tax changes since the adoption of the individual income tax in 1913. The largest tax reduction in history cut individual and corporate taxes by almost $750 billion over a six-year period. Despite this progress in reducing rates, the relief was slight for most individuals as the personal income tax still remains steeply progressive and the maximum marginal tax rate takes a hefty 50% bite out of earnings, savings, and investment. While ERTA initiated the current debate on comprehensive tax reform, the growing Federal deficit has escalated it. No longer is simplicity the only goal of reform proposals. With more and more frequency, the potential for broadening the tax base and increasing Federal tax revenues has crept into reform considerations.

The Treasury Department has been commissioned to complete a report by year-end 1984 on tax alternatives to individual and corporate income taxes. These alternatives include: a simplified tax based on total income, a consumption tax, broadening the base and lowering rates of the current income tax, a national sales tax, and a value-added tax. Of particular popularity has been the concept of a flat rate income tax. However, just as the greatest appeal of the flat rate tax lies in its simplicity, its greatest coup would be in actually being enacted in that form. This issue of Trends will review the current debate on the flat rate tax and its implications for savings and investment.

We do not necessarily believe that Congress and the Administration will substitute a flat rate income tax for our present income tax structure in the near future. Indeed, if we had to bet, we would guess that our Washington representatives will add a consumption-based tax in 1985 or 1986 to reduce the yawning Federal deficits. Nevertheless, the flat rate income tax concept will receive a full hearing over the next year. It is healthy for the capital markets and securities industry to start thinking sooner rather than later about the implications of such an income tax.

The views expressed in this paper are those of the author and do not necessarily reflect the views of SIA.

The Need for Tax Reform

Bracket Creep & Inflation

The primary purpose of the Federal individual income tax is, of course, to raise revenues for the government. To that end, individual income tax receipts, including social security payments, make up slightly more than half of tax collections. However, the income tax system was not designed for an inflationary environment. A progressive system coupled with an environment of rising prices results in taxes expanding as a percentage of income, the climb of marginal tax rates, and a redistribution of tax burdens.1/ Simply stated, in recent years the increases in tax liability for most individuals has been proportionately greater than the increases in their income. This translates into a decline in real after-tax purchasing power as both the progressive income tax and inflation erode increases in income. Bracket creep, the common term for inflation pushing individuals into higher income brackets, was the main impetus behind the start of the flat rate tax movement. While inflation has subsided from the levels that spurred public protest against bracket creep in the 1970s, the growth of two-worker families is but one indication that bracket creep is not necessarily a thing of the past.

Table I shows the phenomena of bracket creep in recent years as well as the Administration's estimates of the effect of ERTA on rates in 1984. Economic growth and the exacerbating effects of inflation contributed to increasing the progressive structure of the tax system. For families with twice the median income, marginal rates escalated from 22% in 1965 to 36% in 1978 and an estimated 43% in 1981 (ERTA not reflected). There were past attempts by policymakers to stem this growing progressivity. However, policymakers are tempted to lower taxes either in equal per capita amounts or in proportion to income. Increased taxes in a progressive tax system combined with tax cuts not in proportion to taxes paid leads to a more progressive system.2/ ERTA represented a significant change from this earlier trend.

1/ "Recent Trends in the Federal Taxation of Individual Income", Quarterly Review, Federal Reserve Bank of New York, Autumn 1980.

2/ Tax Alternatives for America, Hudson Institute, March 1982.

TABLE I

AVERAGE AND MARGINAL INDIVIDUAL INCOME TAX RATES ON MEDIAN INCOME

Year	Median Income	2X Median Income	5X Median Income	10X Median Income
		Average Rates		
1965	7.4	12.2	20.5	36.5
1978	11.6	17.3	30.9	41.0
1981	13.3	18.5	31.7	40.6
1984	11.9	16.0	26.1	32.2
		Marginal Rates		
1965	17.0	22.0	39.0	55.0
1978	22.0	36.0	55.0	66.0
1981	24.0	43.0	59.0	68.0
1984	22.0	33.0	45.0	50.0

Source: Congressional Budget Office

Note: Computed for families of four with typical standard or itemized deductions for the particular income level in the particular year; median income for tax-filing families: 1965, $7,500; 1978, $18,500; 1981, $23,700; 1984, $28,000. The 50 percent maximum rate on income from labor is assumed not to apply. The 1981 tax rates do not include the influence of ERTA.

Effects of Marginal Rates

The steep progressivity and escalating marginal rates in our tax system are taken into account by most individuals in making economic decisions. There are three distinct concerns with high marginal rates: 1. the effect on individuals' incentive to consume in current rather than future periods; 2. the effect on aggregate savings, investment and productivity; and 3. the composition of savings as a result of the incentive to invest in lightly taxed activities.[3] Overall, our tax system has spawned a major disincentive to work harder, take risks, or save and invest, while providing incentives to consume or shelter income.

To stimulate development in various fields, such as energy resources, the tax code provides certain incentives. However, in some cases, unscrupulous promoters have devised abusive schemes which attract thousands of individuals every year. When individuals fall prey to illegitimate tax shelters, funds flow to below market-rate investments and inefficient projects. In 1982, criminal prosecutions were recommended against over 81 promoters of abusive tax shelter plans involving more than 13,000 investors and an estimated tax recovery of $2.6 billion. In addition, some investors time the realization of gains to coincide with periods when they are in low marginal brackets. The distortions created by high marginal rates stifles the efficient allocation of resources, a process critical to the functioning of our capital markets.

Complexity of the Tax Code

Over the years, the income tax system has become a tool not only for raising government revenues but for fostering certain activities deemed socially desirable by policymakers. The tax code consequently has been built up to a byzantine structure of exemptions, exclusions, credits and deductions. Not that the byzantine nature of the tax code has gone unnoticed. There have been several attempts at reform legislation. However, given a patchwork rather than comprehensive approach, reform legislation has served to exacerbate rather than relieve the complexity of the code. An offshoot to the growing complication of the tax code has been growing taxpayer frustration and increased questionning of the fairness of the tax burden. The complexity of the tax code shares almost equal billing with bracket creep as prime movers of the flat rate tax movement.

There is no doubt that some portion of noncompliance stems from the taxpayer's lack of information or confusion over tax laws. Indeed, a few years ago the IRS tested its agents on their knowledge of tax laws and reportedly 80% failed. Nevertheless, whether by taxpayer ignorance or design, IRS estimates indicate that tax evasion is costing Treasury as much as $97 billion in tax revenues a year. Moreover, the tax system is such that an estimated 40% of all taxpayers seek professional help in preparing returns, with tax counseling a booming $60 billion a year industry. In sum, citizens who pay their rightful share believe the current system unfair and confiscatory; those who don't find it full of loopholes; and many find it impossible to figure without the aid of accountants and lawyers.4/

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[3] Analysis of Proposals Relating to Broadening the Base and Lowering the Rates of the Income Tax, Joint Committee on Taxation, 9/24/82.

Administrative Cost

The Commerce Clearing House version of the U.S. tax code, with accompanying regulations, totals over 10,000 pages. Moreover, the IRS hopes to issue 140 tax regulations in 1984 in an effort to reduce its backlog of 392 pending tax regulation projects. These massive regulations entail costs in time and money for the government and the taxpayer. IRS employs about 89,000 individuals, and the Administration budgeted $3.5 billion for the IRS in 1985. The number of specialists trained to interpret the code in the private sector and those trained to administer it in government constitute a "people" resource drain on the economy. In lieu of contributing to the economy in a productive manner, these specialists, depending on whose side they are on, spend their time developing methods to maximize or minimize the impact of the current code.5/

The Flat Rate Tax

In pure theory, a flat rate tax would impose one tax rate across-the-board on all income regardless of source, thus flattening out the progressive structure of our current system and eliminating all credits, deductions, etc. The obvious trade-off to any flat rate proposal is a substantial broadening of the tax base. Given mounting concern over projected Federal budget deficits, the base broadening potential of the flat rate tax has taken on new significance. Put succintly: It's not the simplicity that will appeal to politicians, but the fact that the flat tax can be used as a means of raising taxes, while seeming to cut them.6/ These pending bills propose rates generally ranging up to 30% depending on the definition of taxable income and additional surtaxes in some cases.

4/ "Rating the Flat Rate Tax", The Wall Street Journal, 6/30/82.

5/ "An Overview of the Issues Concerning a Flat Rate Income Tax", Tax Notes, 6/21/82.

6/ "Trojan Horse?", Forbes, 3/14/83.

Any comprehensive tax reform would have to be designed to raise the same amount of revenues as under current law, if not more. In a flat rate system, the broader the tax base, the lower the rate. It is this caveat to the flat rate tax, the broadening of the tax base, that has drawn the most criticism. Senator Russell Long maintains that in response to questions of tax equity, the average voter replies, "Don't tax me, don't tax thee, tax the man behind the tree." Obviously, a pure flat rate tax with an all-inclusive tax base could have the "undesirable" effect of shifting the tax burden to lower income classes. However, most current flat tax proposals via exemptions or widening of tax brackets contain provisions to protect the poor and mitigate the tax burden on the middle classes. For example, the Bradley-Gephardt plan imposes a 14% flat rate and marginal rates of up to 30%, with wealthy individuals paying higher taxes because of the elimination of favorable tax treatment of investment income. There is almost universal agreement that the main stumbling block to comprehensive tax reform would be the dismantling of the current network of credits, deductions, exclusions and exemptions. In addition, opponents of the flat rate tax fear that progressivity would be eliminated.

"Sacred Cows"

In reply to a congressman's query as to what constitutes a "sacred cow", Joseph Pechman, Director of Economic Studies at the Brookings Institute, said "A sacred cow is a tax expenditure which, if you voted to eliminate it, you would lose the next election." With the increase in marginal rates over time came a scurry by legislators of special exemptions to lighten individuals' tax burden. A host of "sacred cows" have ensued as a consequence, with substantial narrowing of the tax base as the end result. Table II shows estimates of revenue losses in 1983 and 1984 from select "tax expenditures" affecting individuals. The full list of individual expenditure items has been gauged at a third of the size of the Federal budget.

TABLE II

SELECTED REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES
(fiscal years, $ millions)

	Individuals	
	1983	1984
Dividend exclusion	$ 465	$ 455
Exclusion of interest on life insurance savings	4,335	4,720
Deductibility of interest on consumer credit	9,215	10,040
Deductibility of mortgage interest/property tax[1]	28,810	31,760
Capital gains[2]	15,335	14,660
Deductibility of charitable contributions[3]	9,275	9,635
Net exclusion of pension contributions & earnings:		
Employer plans	46,585	50,535
IRAs	8,855	9,190
Keoghs	1,460	1,530
Total (All expenditures)	$228,376	$244,626

Source: Tax Notes, 2/6/84

[1] Owner-occupied homes
[2] Other than agriculture, timber, iron ore and coal
[3] Other than education and health

A thorough examination of tax preference items is an essential first step in taking comprehensive tax reform proposals as well as the flat rate tax seriously. Just how much artillery would special interest groups bring to bear on such an undertaking. Table III shows percentage distribution of several tax expenditure items. The removal of the deductibility of mortgage interest and of employer contributions to pension plans would clearly hit the $30-$50,000 income bracket the hardest.

A flat rate tax would by no means be an unqualified windfall as there would be repercussions affecting every segment of society. Removal of the tax benefits of owning a house would seriously impact the housing area. The elimination of the tax exemption accorded municipal bond interest would mean higher borrowing costs for cities and states. The removal of the deductibility of charitable contributions might alter

Table III

PERCENTAGE DISTRIBUTION OF SELECTED TAX EXPENDITURES FOR INDIVIDUALS
Based on Tax Return Data
(1982 Law, 1981 Levels)

AGI ($000)	Mortgage Interest & Property Tax on Owner-Occupied Homes	Net Exclusion of Pension Contributions & Earnings 1/	Capital Gains Excluding Home Sales 2/	Exclusion of Social Security & Railroad Retirement Benefits 3/	Exclusion of Interest on State & Local Bonds 4/	Dividend & Interest Exclusion
0-10	1%	4%	3%	41%	*	5%
10-20	6	13	5	25	*	11
20-30	18	23	9	15	1%	17
30-50	42	34	19	11	5	34
50-100	25	18	24	6	44	25
100+	8	8	40	2	50	8
Total	100%	100%	100%	100%	100%	100%

Source: Office of the Secretary of Treasury, Office of Tax Analysis, 9/23/82.

Note: Details may not add to totals due to rounding; * = less than 1%.

1/ Includes the exclusion of contributions and earnings for employer plans and plans for self-employed and others.

2/ Includes capital gains treatment of coal royalties, iron ore, certain timber and agricultural income, and other income.

3/ Includes the exclusion of disability insurance benefits, OASI benefits and survivors, and railroad system benefits.

4/ Includes the exclusion of interest on pollution control bonds, industrial development bonds, housing bonds for owner-occupied homes and rental housing, student loan bonds, hospital bonds, and general purpose state and local debt.

individuals' generosity, thereby putting pressure on eleemosynary activities. A certain amount of Congressional grandfathering would be inevitable if any proposal resembling a flat rate tax were to be implemented. However, phase-in provisions would have to be kept to a minimum because the very success of a flat rate tax hinges on as broad a tax base as possible.

An overnight enactment of a flat rate tax would play havoc with after-tax income, wealth and cash flow. Long-range investment decisions as well as spending patterns have been based on the current tax system. The value of investments such as municipal securities would decline dramatically. On the other hand, there would be no more need for tax shelters, abusive or legal. Spending patterns and levels would undergo significant transformations with the removal of the deduction of consumer interest. Moreover, the adjustment in after-tax wage income itself would precipitate a change in spending patterns. There are a host of transitional considerations, who would benefit and who would lose would depend on the final form of the new tax law. The winners and losers in a change to a flat rate tax concept is a subject requiring a paper by itself.

Progressivity

The degree of progressivity to be incorporated in a tax system is a subjective judgement. Simply defined, progressivity means that taxpayers with higher incomes pay a greater proportion of their income in taxes. There is much mixed emotions on whether this is a valid principle on which to build a tax system. In a Harris poll, individuals were asked if they felt this principle was "fair and equitable" -- 58% agreed it was fair; 38% did not.[7] On the other hand, a number of tax experts and laymen contend that the concept of declining marginal utility of income is much too subjective and arbitrary to serve as the basis for the tax structure.[8] Vertical equity refers to the tax incidence across income classes and, in our progressive system, is based on the ability to pay. The concept of progressivity, in turn, stems from the marginal utility of income theory -- a dollar of income is considered of more value to a lower income individual than to a higher income individual. That is, a lower income individual must spend his income on necessities, whereas an upper income individual can spend additional income on non-necessities. Depending on the analysis reviewed and the approach taken, our system has been classified as slightly to highly progressive.

7/ "The Flatter Tax Movement Picks Up Steam," Fortune, 7/16/82.

8/ Tax Notes, 6/21/82.

TABLE IV

FLAT RATE TAX AND PROGRESSIVITY

Income	Taxable Income	Tax	Rate
$10,000	$ 5,000	$ 750	7.5%
$20,000	$15,000	$ 2,250	11.3%
$50,000	$45,000	$ 6,750	13.5%
$80,000	$75,000	$11,250	14.1%

Note: Assumes 15% flat tax and $5,000 exemption.

Whatever one's stand on progressivity, claims that any flat rate system would eliminate it are false. With the appropriate use of income exemptions, a flat rate tax can be made quite progressive.[9] Simplicity and progressivity need not be mutually exclusive in a flat rate system. Table IV, which assumes a 15% flat tax rate with a $5,000 exemption, is an elementary example of progressivity incorporated in a flat rate tax system.

Future Concerns

Initial considerations aside, should Congress and the Administration manage to hammer out a flat rate tax system, whither future revenue increases? Any proposed flat tax rate assumes a broadening of the tax base by the elimination of tax preference items. Thus, the revenue implications of a 1% point increase in a flat rate tax could be powerful, since even a percentage point increase would raise revenues substantially. [10] In addition, given estimates of a necessary phase-in time of ten to 15 years, one must wonder what exemptions, deductions, etc. would find their way back into the tax code before the period would be up.

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[9] "Can a Flat Rate Tax Work?", Economic Review, Federal Reserve Bank of Atlanta, 9/82.

[10] The Flat Rate Tax, Price Waterhouse, 1982.

Savings and Investment and the Flat Rate Tax

There has been much concern in recent years over the need to stimulate savings and investment in the U.S. There has been just as much concern over the appropriate way to do it. The U.S. economy has been on a relatively slow growth path in recent years. International comparisons of savings and investment offer one explanation for the poor performance of the economy (see Table V). While the 1981 lowering of the maximum tax from 70% to 50% brought U.S. tax treatment of investment income closer to that of other nations, it still remains among the harshest.

TABLE V

SAVINGS AND INVESTMENT AS A PERCENT OF GROSS DOMESTIC PRODUCT

1972-1981

	U.S.	CANADA	JAPAN	FRANCE	W. GER.	U.K.
SAVING						
SAVING AS % OF GDP	6.8	10.6	19.8	11.5	11.6	7.3
SAVING + CONSUMPTION OF FIXED CAPITAL AS % OF GDP[1]	19.1	21.6	33.2	22.6	22.9	18.6
INVESTMENT						
GROSS NON-RESIDENTIAL FIXED CAPITAL FORMATION AS % OF GDP	14.1	17.5	24.8	15.6	15.3	14.9
GROSS FIXED CAPITAL FORMATION AS % OF GDP	18.5	23.0	32.2	22.3	21.8	18.0

Source: Dunn, Mary Lee and Thorning, Margo, "Expenditure Tax Options," American Council for Capital Formation, 3/2/84. Data derived from NATIONAL ACCOUNTS, 1964-1981, Vol. II, Organization for Economic Co-Operation and Development, Paris, 1983.

1/ SAVING + CONSUMPTION OF FIXED CAPITAL is the equivalent of saving plus depreciation charges.

The goal of ERTA was to promote economic growth by providing incentives for savings, investment, and work effort. Whether ERTA accomplished its goals is still a matter for debate, although we believe the case for its success in promoting economic recovery is becoming stronger every day. The initial repercussion of ERTA plus adverse economic conditions led to the enactment of TEFRA, which was specifically designed to offset some of the tax reductions of ERTA. Nevertheless, according to simulations produced by Data Resources Inc., ERTA had a strong impact on consumption and an even stronger impact on savings. The 1981 and 1982 effect on savings is estimated at $12.2 billion and $31.1 billion, respectively, with the net effect over 1983 - 1985 of both ERTA and TEFRA projected at $58.3 billion, $72.3 billion and $80 billion, respectively.[11]

Thus, along with countless other objectives, the fostering of savings and investment has been incorporated as a goal of tax policy. Indeed, the DRI simulations and the experience with the 1978 capital gains tax cut indicate that individuals are very responsive to after-tax returns on investment. During the two years following the 1978 capital gains tax cut, the stock market indices chalked up impressive gains, particularly those indices representing the smaller capitalized companies traditionally chosen by the individual investor. The increased value placed on the stocks of smaller companies subsequently created a market climate conducive to the initial public offerings of new and emerging companies, which create a disproportionate share of new jobs. Venture capital figures soared, as did shareownership. What is particularly most appealing given current Federal budget problems, capital gains revenues in 1979, 1980, and 1981 exceeded those projected by Treasury before the substantial lowering of tax rates on capital gains in the 1978 Revenue Act.

Some of the current comprehensive tax proposals deal specifically with returns on savings and investment, others do not. The double taxation of corporate-source income is to be prevented in one proposal by a set of specifically designed rules. Some proposals exclude dividends and interest from taxation, others exclude capital gains. By and large, most proposals repeal the 60% exclusion for long-term capital gains. For those concerned with savings and investment, the chief objection to flat rate proposals is the failure to address capital gains and interest and dividend income.

11/ "Taxes, Saving and Investment: Some Empirical Evidence," National Tax Journal, 9/83.

Authors Galper and Steuerle establish three criteria for savings and investment incentives: avoidance of unnecessary and inefficient asset shifts, provisions of incentives at the margin, and a prevention of tax arbitrage through borrowing.[12] While not suggesting that tax incentives necessarily stimulate higher savings rates or that increased savings should be the only goal of tax reform, the authors conclude that none of the existing savings incentives in the tax code meet each of their criteria. Among the tax reform options explored that fulfill the efficient saving incentive criteria is the broader-base, lower-rate tax structure. In terms of savings incentives, the objection that base broadening might increase taxes on individuals with a high propensity to save is discounted on grounds that any proposal can be designed to insure that the taxation of capital income is not increased. Galper and Steuerle conclude that: Although the magnitude of potential tax rate cuts would depend on the degree of base-broadening, even modest efforts toward a broader base could represent an improvement over current savings incentives."

On the other hand, there are proponents of a more comprehensive system who believe that specific incentives for savings should be preserved. Author Calkins, who recommends the return to a tax system designed to raise revenues, advocates that a reduced tax rate applicable to capital gains is one which should be retained -- for many reasons.[13] These reasons include: the "lock in effect," which does not contribute to raising revenue nor productive use of assets; simplicity -- to be "tolerably fair" a system which applies ordinary income rates to capital gains must incorporate a system for adjusting basis for inflation; and a "lower rate on gains from risk-taking than on periodic income and income from services probably has desirable economic effects, notwithstanding the encouragement it also provides for some unproductive investment."

The key to stimulating savings and investment via a flat rate tax or any targeted proposal is the tax rate that ultimately applies to returns. Marginal tax rates in 1984 range from 11% to 50%. Therefore, if a flat tax rate of 14% were imposed on taxable income and the various savings and investment tax preferences removed, many taxpayers would still experience a dramatic lowering of marginal rates. With the effective tax rate at 20% on capital gains for individuals paying the maximum marginal rate, the treatment of capital gains as ordinary income at flat rates up to 19% would in essence mean a lower capital gains tax rate. Of course, the differential between tax rates on ordinary income and capital gains would disappear. There is a dramatic difference in opinions in evaluating how important the differential is in promoting savings and investment compared to focusing only on the expected after-tax return.

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[12] "Tax Incentives for Savings, "The Brookings Review, Winter 1983.

[13] "A Federal Income Tax Designed For Revenue Only," Tax Notes, 4/9/84.

Under some progressive flat-rate type proposals, however, upper income earners could experience higher capital gains taxes. For example, while reducing marginal tax rates from 50% to 30% for upper income earners, the treatment of capital gains as ordinary income under Bradley-Gephardt actually raises the capital gains tax rate by 50%. The "Simple Form" proposal of Senator Mark Hatfield repeals the exclusion for capital gains also, but provides for inflation indexing of the basis price of assets for gains after 1984.

Proposals which sharply increase the effective tax rate on capital gains are disappointing, given the success story of the capital gains tax rate reductions in 1978 and 1981. Most observers believe those rate reductions were successful, ultimately leading to higher rather than lower capital gains tax revenues. In addition, upper income classes paid more in capital gains taxes with lower rates than they did when higher rates were in place. The capital gains tax area appears to be a specific case where "supply-side economics" had an opportunity to work and did so, given sufficient time for the market to respond.

Tax Shelters

Despite the recent lowering of the maximum marginal tax rate, for many taxpayers 50% still represents an unacceptably high rate on marginal earnings. It was basically to prod taxpayers in the upper income groups to invest in developmental-type activities that certain economic incentives were incorporated in the tax code. At times, these provisions of the tax code have been distorted by abusive schemes. This has led to Congressional scrutiny of the entire area of tax shelter investments. Many provisions of TEFRA were aimed at stemming the tide of abusive shelters, and both the Senate and House 1984 tax bills contain proposals to close tax loophooles.

The loss from unproductive investment is two-fold: loss of revenue to the government and loss of funds for capital formation. Under a "pure" flat rate tax, the "building tools" of both productive and unproductive tax shelters would be eliminated. Nevertheless, there will still be a need for individuals to invest in developmental projects, just as there will still be individuals bent on distorting the tax code regardless of tax rates. However, gauging by past experience, the lowering of tax rates on savings and investment has proved efficient and effective in increasing savings in specific vehicles and realizations of capital gains.

TABLE VI

NET LONG-TERM CAPITAL GAINS IN EXCESS OF NET SHORT-TERM LOSS

(all returns, $billions)

AGI ($000)	1977	1978	1979	1980	1981
0-10	$ 5.8	$ 5.7	$ 6.9	$ 6.8	$ 8.4
10-20	6.3	6.8	7.0	7.2	5.5
20-30	6.0	6.7	7.6	6.7	6.1
30-50	7.4	8.6	11.0	9.4	9.6
50-100	6.8	7.9	10.7	11.9	13.0
100-200	4.2	5.2	7.6	8.2	9.9
200+	7.4	7.6	19.5	19.7	24.5
Total	$43.9	$48.9	$70.5	$69.9	$77.1

Source: Statistics of Income, IRS

Note: Figures may not add to total due to rounding.

Table VI shows a 76% increase in capital gains realizations from 1977 to 1981. The pace of realizations distinctly picked up after the 1978 capital gains tax reduction. Moreover, preliminary figures indicate that realizations increased in 1982 from the 1981 figure. Increased realizations translate to increased Treasury revenues. Treasury obtained capital gains taxes of $9.3 billion and $12.4 billion, respectively, in 1978 and 1981.

Savings and Investment Flows

To assume a "pure" flat rate tax would be to treat all investment income, dividends, interest, and capital gains, as ordinary income. One dollar of interest income would be on equal footing with one dollar of earned income, capital gain income, etc. The factors on which savings and consumption decisions are based would undergo radical and dramatic change. Given an absence of deductions, exclusions, and exemptions, many investment vehicles designed around the current tax code to shelter income would be obsolete. The transition period from our current tax code to a flat rate concept would involve major adjustments, as markets seek a new equilibrium based on a new risk-reward investment scale.

While no one can predict what adjustments the transition period might entail, the following scenario is possible. The decision where to place savings and investment funds would be simplified with the elimination of tax preference items. On the other hand, the remaining factors in the savings and investment decision would take on greater importance, such as the degree of risk to be undertaken and the after-tax return. Many short-term instruments, traditional vehicles for savings, would enjoy a tremendous spurt in popularity. The basically riskless nature of bank savings deposits plus the increased after-tax yield would initially attract the majority of increased savings flows.

The counterpart to increased savings flows to short-term money market instruments would be, at least temporarily, depressed prices on other savings and investment vehicles which contain more risk. Corporations would increase pay-out ratios to compete with the greater after-tax yield on competitive instruments. As capital gains and dividends would be taxed at the same rate, investors would place increased emphasis on current rather than future income. The potential appreciation of stocks might be undermined in a shift to a flat rate tax.

Despite the experience of the late 1970s and 1980s, corporate bonds and fixed income instruments have been perceived as low risk investment vehicles, offering both preservation of principal and fixed rates higher than bank investments. Double-digit inflation and government financing needs have pushed returns on corporate bonds to record real levels recently. This volatility has greatly increased the risk of holding fixed income instruments. Thus, to offset the flood of funds to competing investment instruments and depressed prices, returns on fixed instruments would likely climb in quick reaction to a flat rate tax.

The discussion above focuses on shifts in the savings pool among various investment alternatives. If the savings pool were to remain unchanged, there is simply a reallocation of funds to safer, more liquid investments from riskier vehicles until a new equilibrium is reached. For example, the pre-tax yield on short-term money market instruments would decline while that on equities would increase. However, we do not believe that the total savings pool will remain the same. With marginal rates at 20% or less, there will be a shift away from consumption toward savings. This increases the available funds to all investment and savings vehicles, both short-and long-term. The increased pool of funds may be enough to offset or even exceed those funds which shift toward lower risk investments. In other words, the increased amount of savings and investment resulting from lower marginal rates may be enough to offset those funds shifting toward safer vehicles which are now taxed exactly the same as riskier vehicles.

The expansion of funds flowing into IRA accounts supports the case that lower tax rates foster a trade-off between consumption and investment. According to a study by the Life Insurance Marketing and Research Association, the total "new money" -- that is money from current earnings -- invested in IRAs is estimated at 53% of IRA contributions in 1982 and 56% in 1983. In our view, we cannot stress too strongly that the key to retaining incentives for individuals to invest in risky enterprises hinges on the after-tax rate of return. Whatever the flat rate structure, it is crucial that the top marginal rate or rates remain low enough to encourage risk-taking. No one can quantify the exact rate, but a 20% maximum tax rate on capital gains has proven to be effective in stimulating risk capital. Treating capital gains differently than ordinary income is less important, we believe, than ensuring that the after-tax return is attractive enough to warrant increased savings and investment flows. With the differential between ordinary income and capital gains removed, the tax on capital gains should be on real, rather than nominal, gains.

The foregoing sketch represents a cursory look at market adjustments under a "pure" flat rate tax. There are as many scenarios which could unfold as there are investors in the marketplace. In all likelihood, major tax reform would incorporate more than one tax rate, and these rates would have a significant effect on how securities markets would ultimately settle. To be sure, there would be considerable waxing and waning before markets reached equilibrium.

Conclusion

The pros and cons of a flat rate tax system can be discussed ad infinitum, with elaborate scenarios used to present either side of the case. The basic point is that policymakers can no longer rely on a patchwork approach to raising revenues. The functioning of the current tax system is beginning to deteriorate: tax evasion and the deficit are expanding. The proposed 1984 tax bills contain many provisions aimed at closing tax loopholes created by prior tax laws.

Chances of enacting a pure flat rate tax are obscure. Most proposals built on the flat rate concept have incorporated provisions addressing the main objection to such a tax --an increased tax burden on the lower and middle income classes. Overall, these proposals encompass a dramatic lowering of marginal tax rates. While tax policy is not the sole driving force behind the decision to work harder or save and invest more, lower tax rates would provide greater incentives. Whatever the final outcome of the much heralded tax reform of 1985, the current tax system is obviously in need of serious rethinking. The concept of flat rate taxation deserves a full hearing. The capital markets and securities industry must participate in this debate sooner rather than later.

Carolyn Hildebrandt
Assistant Vice President

SECURITIES INDUSTRY STATISTICS

VOLUME

	APRIL 1984	YEAR-TO-DATE 1984	APRIL 1983	YEAR-TO-DATE 1983	% CHG. Y-T-D 1984-1983
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	85.9	93.1	89.6	86.5	7.6%
AMEX (MILS.)*	5.9	6.2	8.6	8.5	(27.1)
NASDAQ (MILS.)*	57.4	60.3	62.3	59.2	1.9
REGIONAL EXCHANGE (MILS.)*	13.9	14.1	12.9	12.1	16.5
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	56,351	265,354	62,504	244,185	8.7
AMEX (MILS.)	1,664	7,243	2,576	10,022	(27.7)
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	6,900	29,290	8,994	31,483	(7.0)
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	13,376	54,751	15,611	62,382	(12.2)
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	49.6	49.3	44.2	43.5	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	8,793	37,868	5,994	23,264	62.8
AMEX OPTIONS	2,644	12,617	2,845	11,770	7.2
COMMODITY	11,652	49,249	8,738	33,696	46.2

** MONTHLY AVERAGE*

YIELDS

(MONTHLY AVERAGES)

	April 1984	April 1983	Basis Point Change April 84 April 83
BOND BUYER INDEX (20 BOND)	9.96	9.0	0.96
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	12.81	11.51	1.30
Baa CORPORATE	14.31	13.29	1.02
RATIO Aaa CORPS. TO Baa CORPS.	0.90	0.87	0.03
MUNICIPAL BOND YIELDS (MOODY'S)	9.54	8.28	1.26

PRICES

(END OF MONTH)

	April 1984	April 1983	% Change April 84 - April 83
DOW JONES INDUSTRIALS	1170.75	1226.20	(4.5%)
STANDARD & POOR'S 500	160.05	164.42	(2.7)
NYSE COMPOSITE	91.98	94.27	2.4
AMEX MARKET VALUE INDEX	210.40	213.90	(1.6)
VALUE LINE COMPOSITE	179.91	190.52	(2.6)
NASDAQ COMPOSITE	247.44	293.06	(15.6)

MUTUAL FUNDS
(DOLLARS IN MILLIONS)

	April 1984	Yr.-to-Date 1984	April 1983	Yr.-to-Date 1983	% Change Y-T-D 1984 - 1983
NET SALES*	2,078.3	7,150.6	2,292.9	6,584.3	8.6%
NET PURCHASE OF COMMON STOCK*	513.9	1,801.1	1,480.8	4,162.8	(56.7)
NET PURCHASE OF OTHER SECURITIES*	749.6	1,776.9	312.4	593.6	199.3
MUTUAL FUND CASH POSITION	12.3	-	10.6	-	-

*EXCLUDES MONEY MARKET, MUNICIPAL BOND AND OPTION FUNDS

MARGIN DEBT

	April 1984	April 1983	% Change Apr.84 - Apr.83
MARGIN DEBT OUTSTANDING ($MILS)	22,830	15,260	49.6
NET CHANGE IN MARGIN DEBT ($MILS)	7,570	3,310	-
% OF ACCOUNTS WITH EQUITY UNDER 40%	12.0	9.0	-

* ALL TIME HIGH

UNDERWRITING
(DOLLARS IN MILLIONS)

	April 1984	Year-to-Date 1984	April 1983	Year-to-Date 1983	% Change April-April	% Change 1984-1983
CORPORATE FINANCING (Gross New Issues)						
Total	6,530	25,527	11,837	39,879	(44.8)	(36.0)
Competitive						
Negotiated						
Common Stock	781	3,355	3,545	13,454	(78.0)	(75.1)
# Of Common Stock Issues	72	294	121	407	(40.5)	(27.8)
Preferred Stock	417	1,617	624	4,385	(33.2)	(63.1)
# Of Preferred Stock Issues	6	26	12	61	(50.0)	(57.4)
Corporate Debt	5,331	20,555	7,667	22,040	(30.5)	(6.7)
# Of Corporate Debt Issues	45	209	83	254	(45.8)	(17.7)
MUNICIPAL FINANCING* (Gross New Issues)						
Total	11,097	33,729	15,707	39,922	(29.3)	(15.5)
Notes	6,093	14,231	5,875	12,851	(3.7)	10.7
Bonds	5,005	19,498	9,819	27,058	(49.0)	(27.9)
# of Bond Issues	332	1,222	656	1,580	(49.4)	(22.7)
Negotiated Bonds	3,120	13,313	6,573	18,453	(52.5)	(27.9)
Revenue Bonds	2,946	11,579	5,868	18,661	(49.8)	(37.9)

*Preliminary Figures

FINANCIAL DATA FOR NYSE FIRMS DOING A PUBLIC BUSINESS
(MILLIONS OF DOLLARS)

	First Quarter 1984	Yr-to-Date 1984	First Quarter 1983	Yr-to-Date 1983	% Change 1st.Q. 1984 1st.Q. 1983	% Change 1984 - 1983
REVENUE						
SECURITIES COMMISSION INCOME	1,972	1,972	2,112	2,112	(6.6)%	(6.6)%
REALIZED AND UNREALIZED GAIN OR LOSS IN TRADING AND INVESTMENT	1,947	1,947	2,178	2,178	(10.6)	(10.6)
PROFIT OR LOSS FROM UNDERWRITING AND SELLING GROUPS	553	553	843	843	(34.4)	(34.4)
TOTAL REVENUE	7,944	7,944	7,189	7,189	10.5	10.5
TOTAL EXPENSES	6,947	6,947	5,896	5,896	17.8	17.8
NET INCOME BEFORE TAXES	497	497	1,293	1,293	(61.6)	(61.6)
PERCENT OF FIRMS SHOWING LOSS	31.3%	31.3%	10.4	10.4	-	-

RECENT INTERESTING READING AND STATISTICAL MATERIAL

ITEM	DESCRIPTION	SOURCE
Transcript: SIA Trends Conference on Deregulation: Opportunities & Pitfalls	153-page transcript records varied perspectives on how the industry might cope with the inevitable trend toward deregulation. The alternative strategies under deregulation are explored, as well as the specific strategies employed by four different types of firms. In addition, strategies for obtaining capital and distribution are discussed. The keynote speaker, Charles L. Brown, gives an intriguing look at AT&T after divestiture.	SIA Research Department $25 Conference attendees; $50 all others
Securities Industry Yearbook 1984-85	Primary reference source on SIA member firms. Hard-cover, 600-page edition contains 5 sections: Firm rankings by capital, Information on publicly-traded firms, Detailed firm data, Geographic listings, and Industry & Market statistics.	SIA Yearbook Dept. $45 members; $70 non-members (+ sales tax for NY purchases)
The Investment Banking Process for Primary Equity Securities and the Effects of SEC Rule 415	Doctoral dissertation examining the investment banking process for primary securities issues with regard to SEC Rule 415. Major findings provide food for thought: 1. Rule 415 may not aid issuers if overall costs and benefits are considered, 2. Role of the investment banking firm reduced by Rule 415, and 3. SEC's Rule 415 is flawed.	Gary Gray E.F. Hutton Philadelphia
"Side-by-Side Comparison of the Tax Provisions of the House and Senate Versions of HR4170"	150-page reproduction of pamphlet describing pending tax-increase legislation, prepared for the use of the conferees by the Joint Committee on Taxation. Each item described in terms of present law, House bill and Senate amendment.	Bureau of National Affairs Distribution & Customer Service Center 9439 Key West Avenue Rockville, Md. 20850 $6

ITEM	DESCRIPTION	SOURCE
Last Half 1983 Director of Corporate Financing	Semi-annual directory covers many full year 1983 statistics, with alphabetical listing of and details on issuers and underwriters in second half of the year. Statistical reference section includes: monthly underwriting records, underwriting credits ranking of leading investment bankers, and initial public offerings.	Investment Dealers' Digest 150 Broadway New York, N.Y. 10038 $125
"Merger-Activity and Leveraged Buyouts: Sound Corporate Restructuring or Wall Street Alchemy?"	Report discusses leveraged buyout financing to acquire companies or subsidiaries. These transactions involve borrowing most of the purchase price and using the assets of the company or subsidiary acquired as collateral for the loan. Financial and tax aspects of the transactions are discussed, together with issues of risk exposure and fairness to shareholders.	Congressional Resear Service Library of Congress No. 84-643E 5/18/84
NASD 1983 Fact Book	By virtually every measure of performance and growth, the year 1983 was an outstanding one for the NASDAQ market. Data included in report: volume & high-low statistics for each NASDAQ security, and geographic distribution of market makers.	NASD 1735 K Street, N.W. Washington,D.C. 2000
"SIA, Bank Industry Turf Wars Rage On in Court"	Some time, in the coming weeks, the Supreme Court will hand down decisions in two cases that are likely to chart the course for future deregulation of the financial services industry. Article summarizes past SIA bank-broker litigation and determination.	Legal Times 5/28/84

Securities Industry Trends

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AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

A8825-1

Vol. X No. 4 July 30, 1984

SECURITIES INDUSTRY PERFORMANCE: 1983 AND 1H 1984

HIGHLIGHTS

1. For the securities industry, after-tax ROE declined to 19.8% in 1983 from 22% in 1982. ROE fluctuated widely, ranging from a high of 31.3% in 2Q 1983 to a low of 6% in 4Q 1983.

2. Commission revenues increased substantially in 1983, as equity prices and share volume rose. Underwriting revenues increased by 53%, with revenues from underwriting equity securities rising by 130% because of the surge in IPOs.

3. Industry revenues and expenses were adversely affected by interest rates which began rising in May 1983. Revenues decreased 5% in the 2H 1983 while expenses rose 7%. Interest expense soared 43% in 2H 1983 while so-called fixed expenses increased 12%.

4. The industry continues to become more capital intensive. In 1983, capital climbed 3[illegible]% or $3.4 billion. Since 1979, capital has climbed at a very rapid 30% compound annual growth rate.

5. NYSE and NASD discounters' 1983 after-tax ROE was 21.9%. Discounters' market share of retail commissions rose to 9% from 6.3% in 1982, while their estimated share of retail volume rose to 18% from 12.6% in 1982.

6. Though 1Q 1984 after-tax ROE increased to 9% from 6% in 4Q 1983, we estimate industry pre-tax net income fell within a range of -$50 million to +$50 million during 2Q 1984. In terms of industry profitability, the 1H 1984 was the worst 6-month period since October 1, 1977-March 31, 1978.

Securities Industry Association
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INTRODUCTION

This *Trends* report is Part I of a two part issue reviewing the securities industry's performance in 1983 and 1Q 1984, including a profitability projection for 2Q 1984. The extensive coverage, analysis and data for the industry necessitates two parts. Part I will examine the aggregate industry's 1983 and 1Q 1984 performance -- revenues, expenses and profitability -- as well as that of discounters and estimates 2Q 1984 profitability. Part II will cover the same ground on a firm category basis (except discounters). Although 1983 industry data and performance are dated by this time, an analysis of the previous full year is helpful for comparisons with prior and future years.

ECONOMIC CONDITIONS

The 1983 economic environment created confusion in the financial markets. Strong economic activity adversely affected the capital markets while slower economic activity seemed to boost security prices. Financial markets were wary of the potential clash between expansionary fiscal policy and monetary policy aimed at preventing a resurgence of inflation. Significant Federal government deficits were projected for fiscal year 1984 and the rest of the decade. Concern was evident over the potential strain in funding triple digit deficits and rapid expansion in the private sector's credit needs.

Economic conditions in early 1983 were favorable for the securities industry. Both monetary and fiscal policies were expansionary but upward pressure on interest rates remained absent because of the weak economy.

The economic recovery picked up momentum in 2Q 1983 as real GNP rose at an impressive annual rate of 9.7 percent. This spurt in expansion resulted from increases in personal consumption and investment. Consumption climbed with a rise in consumer confidence based upon expectations that the recovery would continue, low inflation, relatively stable interest rates and consumers' strong financial position. Investment climbed because of residential construction and a sharp decline in drawing down inventories.

Monetary policy was tightened by the Federal Reserve because of the climb in GNP. Both short-term and long-term interest rates reached their troughs in early May. Concern over strong economic growth, monetary targets and the deficit resulted in rates rising during the rest of the quarter. The securities industry continued to prosper in 2Q 1983 as stock market and underwriting activity both increased while interest costs rose only moderately.

Real GNP expanded at an annual rate of 7.6% in 3Q 1983. Consumption increased moderately as income growth was limited due to adverse weather and labor strikes. Investment accounted for almost three-quarters of real GNP's 3Q 1983 rise. The most important factor in this rise was inventory accumulation which rose for the first time since 4Q 1981.

The tightening in monetary policy stopped in mid-August. Generally, both short-term and long-term interest rates peaked during the first-half of August and then declined. Still, interest rates rose relative to 2Q 1983. Stock prices declined in August but then increased, ending the quarter slightly above the 2Q 1983.

Economic activity continued rising in 4Q 1983 but at a slower pace as real GNP increased 5.0%. Again, consumers were mainly responsible for this growth although nonresidential fixed investment also rose. Inventory accumulation continued because of the low inventory-to-sales ratio.

Monetary policy eased somewhat in 4Q 1983. M1 and M2 remained in the lower portion of their target bands. Interest rates were relatively stable until December. Favorable economic news and large Treasury borrowings caused rates to rise. Security prices declined over fears that monetary policy would tighten and interest rates would rise further. This trend affected industry revenues adversely while sharply increasing interest expense, the largest single expense for the industry.

PROFITABILITY

The securities industry earned an after-tax ROE of nearly 20% in 1983 (Table 1). Since 1979, after-tax ROE has averaged an impressive 21%. On a quarterly basis, after-tax ROE ranged from 6% to 31% last year. During the first-half of 1983, after-tax ROE reached a record 31%, exceeding that of 1980, but profitability plummeted in the last six months to the lowest level during the past five years except for the first-half of 1982. Using the standard deviations of quarterly profits over the 1979-1983 period, volatility in 1983 ranked only behind 1982.

Interestingly, ROE was lowest in the two years when there was the least volatility, 1979 and 1981. In more recent years, industry volatility has become greater rather than smaller. Given the industry's greater reliance on trading profits, the increased volatility of earnings is no great surprise to those trying to "weather the storm" of swings in security prices.

Table 1

Securities Industry After-Tax ROE

Annual After-Tax ROE		1983 Quarterly After-Tax ROE		Standard Deviation of Quarterly After-Tax ROE	
1979	16%	I	30%	1979	2.4
1980	26	II	31	1980	9.0
1981	19	III	15	1981	7.2
1982	22	IV	6	1982	14.6
1983	20			1983	10.6

Industry profitability declined from 22% in 1982 to 20% in 1983 despite pre-tax net income climbing 26% to $3.8 billion. Essentially, the decrease in ROE occurred because the addition of significant resources did not generate comparative revenue and profitability gains. Key ratio analysis verifies this conclusion (Table 2). ROE is affected by profit margin, asset turnover and leverage. The asset turnover ratio is considered a rough "productivity" measure of assets. The leverage ratio indicates the degree debt is relied upon compared to equity. In 1983, ROE was adversely affected as the asset turnover ratio declined.

Last year, the pre-tax profit margin declined because of both higher debt and the 35% jump in non-interest expenses while proximate non-interest revenues (excluding margin interest and other-related revenues) rose 34%. The pre-tax profit margin was 18% during the first-half of 1983, but dropped to less than 8% during the last six months. During this latter period, proximate interest revenues (including margin interest and other-related revenues) rose 33% while interest expense soared 43%. Non-interest revenues actually fell in the third and fourth quarters by 16.7% and 2.4%, respectively. Non-interest expenses did not decrease in line with the drop in revenues and actually rose 3.4% in the fourth quarter. As a result, net income dropped 62% in the last-half of 1983.

Table 2

Key Ratio Analysis

Ratio Name	Mathematical Ratio	1982	1983
Asset Turnover Ratio	$\frac{\text{Revenues}}{\text{Average Assets}}$	.180	.163
x	x		
Pre-tax Profit Margin	$\frac{\text{Pre-tax Earnings}}{\text{Revenues}}$	13.1%	12.9%
x	x		
Tax Retention Rate	$\frac{\text{Net Income}}{\text{Pre-tax Earnings}}$	54.0%	54.0%
x	x		
Leverage Ratio	$\frac{\text{Average Assets}}{\text{Average Equity}}$	17.2	17.3
=	=		
Net Return on Equity	$\frac{\text{Net Income}}{\text{Average Equity}}$	22.0%	19.8%

Even though the securities industry's after-tax ROE declined in 1983, it still remained among the most profitable industries. According to Business Week, the four most profitable industries were drugs (19.6%), beverage (17.9%), personal care products (16.9%), and automotive (16.7%).1/ Banks and bank holding companies' after-tax ROE was 11.6%. Interest by organizations outside the industry in acquiring securities firms is accounted for by the impressive profitability in recent years, although such interest waned with the downturn in profitability beginning in the 3Q 1983.

1/ Business Week, March 21, 1984, pp. 20-63.

REVENUES

Commission Revenues

Commission revenues increased to over $8.3 billion in 1983 from under $6 billion in 1982, close to a 40% increase (Table 3).

Table 3

Commission Revenues
(millions of dollars)

Commissions	1982	1983	% Change
Listed Equities on Exchanges	$4,447.9	$6,129.7	37.8%
Listed Equities Executed OTC	61.1	112.3	83.8
Listed Options	736.2	796.6	8.2
Other	726.2	1,304.1	79.5
Total	$5,971.8	$8,342.9	39.7%

Commission revenues vary with volume and equity prices. Securities prices on most national exchanges registered increases in 1983. For example, the average price of shares traded on the NYSE increased from $29.67 in 1982 to $35.40 in 1983, a 19% increase. On the regional exchanges, the average price of shares traded increased to $31.67 in 1983 from $28.18 in 1982, a 12% increase. Combined share volume on the NYSE, AMEX, and the regional exchanges climbed to over 27 billion shares from 20 billion shares in 1982, a 35% increase. Consequently, the value of shares traded on exchanges increased by 57% to $904 billion from $575 billion in 1982. Commissions did not increase as much as the value of shares traded because of increasing order size. For example, on the NYSE, the average size of a trade increased from 1,305 shares to 1,434 shares, nearly 10%. Large block transactions (10,000 shares and more) constituted 9.8 billion shares of the 21.5 billion shares traded on the NYSE in 1983, or 45.6% of share volume, up from 41.0% in 1982.

On a quarterly basis, commission revenues increased from the 1Q to 2Q, and then declined over the last two quarters of the year (Table 4). This pattern reflects the peaking of both trading volume and stock prices in the 2Q 1983.

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Table 4

1983 Quarterly Commission Revenues
(millions of dollars)

Commissions	1Q	2Q	3Q	4Q
Listed Equities on Exchanges	$1,565.2	$1,738.0	$1,438.5	$1,388.0
Listed Equities Executed OTC	27.7	31.9	29.4	23.3
Listed Options	195.2	219.3	194.5	187.6
Other	322.4	400.9	312.0	268.8
Total	$2,110.7	$2,390.1	$1,974.4	$1,867.7

Trading Profits

Industry trading profits increased to $6.8 billion from $5.9 billion in 1982, a 15.3% increase. However, trading profits from debt securities, the largest source in 1983, remained almost unchanged from 1982 at $4.4 billion. Profits from trading other instruments, however, increased dramatically. For example, trading profits from market making in OTC securities more than doubled, going from $654 million to $1.4 billion, a 111% increase. The trading of options on national exchanges produced profits of $63.6 million in 1983, up from $6.7 million in 1982. Trading profits in the "other" category, which includes commodity futures, financial futures, futures on stock indices, etc., increased by 20% to $981 million from $818 million in 1982 (Table 5).

Table 5

Trading Profits
(millions of dollars)

	1982	1983	% Change
OTC Market Making	$ 654.4	$1,380.9	111.0%
Debt Securities	4,454.3	4,417.8	(0.8)
Options	6.7	63.6	849.3
Other	817.9	981.3	20.0
Total	$5,935.0	$6,838.8	15.2%

Trading profits on debt securities consists of two components: interest payments received on debt securities held, and gains (losses) on positions. Trading profits on debt securities declined slightly in 1983 (0.8%) to $4.41 billion from $4.45 billion in 1982. Such profits are basically a function of interest rate trends. The trend on Moody's corporate Aaa-rated and Baa-rated bonds indicated the general direction of interest rates in 1982 and 1983. In 1982, interest rates on Moody's Aaa and Baa bonds declined more or less continously. The average yield each quarter for both types of bonds was lower than that for the previous quarter. From July 1982 to December 1982, the yield on Aaa-rated bonds declined by 278 basis points and on Moody's Baa-rated corporate bonds, 266 points. Aaa-rated corporate bonds declined only slightly more in 1Q 1983, while Baa-rated corporates declined significantly more. From October 1982 to March 1983, Baa-rated corporate bonds declined by over 100 basis points. Both Baa and Aaa corporate bonds continued to decline into 2Q 1983, Aaa bonds only slightly and Baa bonds more significantly. Yields on both types of bonds started to rise toward the middle of 2Q 1983 and continued to rise throughout the remainder of the year.

Underwriting Revenues

Total securities industry underwriting revenues increased dramatically in 1983 to $3.5 billion from $2.3 billion in 1982, a 53% increase. Revenues from equity securities underwriting increased 130% to $754 million from $327 million in 1982. As a result, equities accounted for 21% of total underwriting revenues, compared to only 14% in 1982. Revenues from the underwriting of non-equity securities increased by 40% to $2.8 billion in 1983 from under $2 billion in 1982 (Table 6).

Table 6

Underwriting Revenues
(millions of dollars)

	1982	1983	% Change
Equity Securities	$327.4	$754.2	130.4%
Non-Equity Securities	1,988.4	2,782.5	39.9
Total	$2,315.8	$3,536.7	52.7%

On a quarterly basis, underwriting revenues increased from 1Q 1983 to 2Q 1983 and then declined in the last two quarters. This pattern was followed by underwriting revenues from non-equity securities, whereas underwriting revenues from equity securities continued to increase through the 3Q 1983 (Table 7).

Table 7

1983 Underwriting Revenues
(millions of dollars)

	1Q	2Q	3Q	4Q
Equity Securities	$158.8	$ 208.5	$217.7	$169.2
Non-Equity Securities	691.6	974.5	653.7	643.7
Total	$849.4	$1,003.0	$871.4	$812.9

The large increase in 1983 equity security underwriting revenue is explained by the surge in common stock offerings, particularly IPOs. Common stock offerings were up from $16.5 billion (680 issues) to $39.1 billion (1,633 issues) in 1983, a rise of 137% and 140% in value and number, respectively (Table 8).

Table 8

Underwriting Activity
(billions of dollars)

	1982	1983	% Change
Corporate Bonds*	$57.2	$54.6	(4.5)%
Number of Issues	642	643	0.16
Preferred Stock*	5.3	8.7	64.2
Number of Issues	96	132	37.5
Common Stock*	16.5	39.1	137.0
Number of Issues	680	1,633	140.1
Total Corporate*	78.9	102.4	29.8
Number of Issues	1,418	2,408	69.8
IPOs**	1.4	12.6	800.0
Number of Issues	222	888	300.0
Municipal Bonds (short term and long term)***	123.9	123.4	(0.4)
Number of Issues	9,858	9,462	(4.0)

* Source: Investment Dealers' Digest
** Source: Going Public, Howard & Co.
*** Public Securities Association

Initial public offerings alone increased from $1.4 billion (222 issues) to $12.6 billion (888 issues) in 1983. Hence, 50% of the increase in equity offerings in 1983 was accounted for by initial public offerings.

In 1982, underwriting revenues grew by 47.2%. The market share of the top ten firms increased from 50.3% in 1981 to 57.8% in 1982. The top twenty-five firms saw their market share increase from 73.5% in 1981 to 80.5% in 1982. In 1983, underwriting revenues rose by 52.7%, and the share of the top ten firms declined from 57.8% in 1982 to 46.2% in 1983. The share of the top twenty-five firms declined to 76% from 80.5% in 1982 (Table 9). Hence, the increase in concentration of underwriting revenues among the top 10 firms in 1982 was at the expense of the smaller firms, with no change in concentration among the top 11-25 firms. In 1983, there was a decline in underwriting revenues concentration among the top 10 firms, with an increased market share among both the top 11-25 and smaller firms. This decline in concentration is attributable to the increase in equity offerings, particularly IPOs, where smaller firms play a larger role in underwriting and distributing securities.

Table 9

Concentration in Underwriting Revenues
(millions of dollars)

	1982		1983	
	$	%	$	%
Top 10	$1,337.7	57.8%	$1,633.4	46.2%
Top 11-25	527.4	22.8	1,056.3	29.9
Top 25	1,865.1	80.5	2,689.8	76.0
Rest of Industry	450.7	19.5	847.6	24.0
Industry	$2,315.8	100.0%	$3,536.7	100.0%

Margin Interest

Margin interest revenues rose 6.3% in 1983 after plunging 30% in 1982. However, net margin interest income, not gross margin interest revenues, is the important variable for profitability. The trend in net margin interest is suggested by available data including NYSE customer margin debit balances, free credit balances, the broker call rate and the estimated rate or rates charged margin customers (Table 10). Other data not available but useful in determining the profitability of margin business are cash debits against which free credits are used and revenues received by firms on stocks loaned on customer margin accounts. Available data indicate that net margin interest revenue rose significantly in 1983 as customer margin debit balances soared 48% and free credit balances climbed 24%.

Table 10

Indicators of Net Margin Interest Income*
(billions of dollars)

	NYSE Customer Margin Debit Balances	Free Credit Balances	Average Broker Call Rate	Estimated Rate Charged Margin Customer
1981	$14.20	$ 9.04	17.85%	19.35%
1982	12.04	11.65	13.43	14.90
1983	17.78	14.41	10.09	11.44

* All data are averages.

Other Income

Other-related revenues to the securities business basically include interest on repos, M&A fees, private placement fees and interest earned on investments. In 1983, other-related revenues increased nearly 12% after climbing 33% in 1982. Interest on repos is believed to be the largest component of this revenue item and probably rose moderately in 1983. The overnight average repo rate dropped from 11.62% to 9.06%, while average reverse repos climbed 35%, from $42.1 billion in 1982 to $57.1 billion in 1983.

Additional components of other-related revenues also contributed to the 1983 rise. Fees from both M&A activities as well as private placements exceeded those for 1982. M&A activity, as reported by W.T. Grimm, was $73.1 billion in 1983, up from $53.8 billion in 1982. Meanwhile, private placements climbed to $36.4 billion from $22.1 billion in 1982. The 1983 level represented a record and reflected the increased volume of mortgage pass through certificates, CDs, and limited partnership interests.

EXPENSES

Trends in three broad categories of industry expenses are reviewed: employment; interest; and "fixed expenses" -- occupancy & equipment costs, communications and electronic data processing (EDP) equipment costs.

Employment Costs

Nearly all reported employment costs consist of registered representatives' compensation and clerical/administrative expenses. RR compensation includes commissions derived from purchase/sale of securities in the primary and secondary markets and on transactions where the firm acts as a market maker. RR compensation increased by 40% to $5.7 billion from $4.1 billion in 1982 (Table 11).

Table 11

Employment Expenses
(millions of dollars)

	1982	1983	% Change
Registered Rep. Compensation	$4,105	$ 5,748	40.0%
Clerical/Administrative	3,694	4,888	32.3
Total	$7,799	$10,636	36.4%

Clerical and administrative expenses - the third largest industry expense category in recent years - increased by $1.2 billion in 1983 (32.3%) to $4.9 billion. Part of the $1.2 billion increase in clerical/administrative costs was due to the fact that the industry had an additional 22,100 support personnel at year-end 1983 compared to year-end 1982, or an increase of 20%.

Interest Expense

Industry interest expense is basically a function of three variables: interest rates, leverage, and assets (really liabilities). In 1983, interest expense rose by $595 million from 1982 levels (Table 12). This occurred even though 1983 interest rates were considerably below 1982 levels as average industry assets rose by approximately $50 billion while industry leverage remained fairly constant at about 17.

On a quarterly basis, there were increasingly large changes in industry interest expense which rose by $89 million, $304 million and $368 million, during the 2Q 1983, 3Q 1983 and 4Q 1983, respectively.

Interest rates continued to decline well into the 2Q 1983 but began to rise in May 1983. Industry assets rose by $14 billion, $22 billion, and $24 billion in the 2Q, 3Q and 4Q, respectively. A larger amount of industry assets was financed by debt. Thus, interest expense skyrocketed in the 2H 1983 even as industry gross revenues were declining. During the 3Q, interest expense rose nearly 24% and another 23% during the 4Q.

Table 12

Components of Interest Expense
(billions of dollars)

	Average Liabilities		Interest Expenses	
	Dollars	% Change	Dollars	% Change
Annual				
1982	$121.1		$5.46	
1983	170.6	41%	6.05	11%
1983 Quarterly:				
I	$155.0	6%	$1.20	(6)%
II	153.0	(1)	1.29	7
III	169.9	11	1.60	24
IV	191.9	13	1.96	23

Fixed Expenses

Fixed expenses are not supposed to vary much with changes in revenues. In the securities industry, expense items usually considered fixed are occupancy and equipment, communications, and EDP equipment costs. In 1983, these fixed expenses increased by 26%, a startling large precentage, although less than the 34% increase in total expenses less interest expense (Table 13). Occupancy and equipment costs climbed nearly 34% as the number of sales offices of NYSE firms doing a public business increased 13.5% to 5,876 while the number of RRs jumped 17%, to 69,960.

EDP equipment costs and communications expense also rose substantially. These large expenditures were driven by technological developments and by firms continuing to gear up to handle larger and larger numbers of transactions. Naturally, as revenue growth slowed down during the 4Q of 1983 and fell during 1H 1984, the upward trend in fixed costs put enormous strain on profit margins.

Table 13

So-Called Fixed Expenses
(millions of dollars)

	Dollars			Percent Change	
	1981	1982	1983	1982	1983
Occupancy & Equipment	$ 664	$851	$1,137	28%	34%
EDP Equipment Costs	218	272	342	25	26
Communications	1,087	1,269	1,537	17	21
Total	$1,969	2,392	$3,016	21%	26%
Total Industry Exp. Less Interest Exp.	$11,967	$14,623	$19,672	22%	35%

CAPITAL

The diversification of the industry toward principal business along with regulatory changes such as Rule 415 have required firms to become more capital intensive. In 1983, the jump in capital was a record $3.4 billion, or 32%. Since 1979, capital has climbed at a rapid 30% compound annual growth rate. In addition, average capital per employee increased from $524,000 in 1979 to nearly $1.1 million in 1983. Capital per RR rose from $1.4 million in 1979 to about $2.6 million in 1983.

Most of the 1983 climb resulted from an increase in retained earnings and additional infusions of capital (Table 14). Almost all of the jump in retained earnings occurred in the first-half of the year when industry profitability was at a record level. However, additional infusions took place in the fourth quarter despite the drop in industry profitability.

Table 14

Capital
(millions of dollars)

	1982	1983			
	4Q	1Q	2Q	3Q	4Q
Ownership Equity					
Retained earning	$ 3,859	$ 4,354	$ 4,933	$ 5,168	$ 5,160
Paid-in capital	2,314	2,417	2,463	2,630	3,209
Partnership	2,285	2,494	2,627	2,841	2,895
Other	479	508	530	523	531
Total	8,937	9,773	10,553	11,162	11,795
Subordinated Liabilities	1,842	1,876	2,093	2,241	2,503
Grand Total	$10,779	$11,649	$12,646	$13,403	$14,298

DISCOUNTERS

In 1982, we began analyzing the performance of discounters because of widespread interest in this segment of the industry. Included in this analysis are discount firms which are members of the NYSE or NASD. Revised discounter data are presented here for 1982 and 1983. We developed our own discounter list in 1983 which was utilized in the November 1983 Trends issue analyzing discounters' 1982 and first-half 1983 performance. Further refinements have been made to this list based upon new survey work.

NYSE and NASD discounters' 1983 after-tax ROE was 21.9%. However, quarterly profitability ranged from 39% for the 1Q 83 to less than 2% in the 4Q 1983 (Table 15). This volatility occurs because of their dependence on commissions from retail accounts. In 1983, NYSE and NASD discounters' commissions totaled $331 million or 72% of total revenues. The lack of both revenue and customer diversification results in volatility whenever changes occur in retail activity. At the same time, expenses change less than revenues. For example, in the 4Q 1983, revenue dropped 11%

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but expenses declined by less than 1%. So-called fixed expenses (communications, occupancy & equipment, and EDP equipment costs) rose almost 18% in 4Q 1983 because of prior commitments made during more prosperous quarters.2/

Table 15

1983 NYSE and NASD Discounters
(millions of dollars)

	1Q	2Q	3Q	4Q	Year	Standard Deviations
Revenues	$107.5	$125.2	$119.6	$106.2	$458.5	7.2
Expenses	88.8	105.5	105.8	105.0	405.1	6.5
Pre-Tax Net Income	$ 18.7	$ 19.7	$ 13.8	$ 1.2	$ 53.4	6.6
After-Tax ROE	39.3%	35.6%	21.5%	1.7%	21.9%	13.2
Pre-Tax Profit Margin	17.4%	15.7%	11.5%	1.1%	11.6%	5.7

NYSE and NASD discounters' market share of retail commissions and retail share volume have been tracked. In 1983, their estimated market share of retail commissions increased to 9% from 6.3% in 1982 (Table 16). Their estimated market share of retail share volume rose to 18% compared to 12.6% in 1982. Discounters' larger 1983 market share resulted from increased promotional activity and recognition resulting from the participation of large deposit-taking institutions and insurance companies. Still, discounters' market share of total industry revenues amounted to little more than 1%.

2/ Based only on NYSE discounters' expenses which account for more than 70% of NYSE and NASD discounters' total expenses.

Table 16

NYSE and NASD Discounters' Market Share, 1982 and 1983
(millions of dollars)

	1982	1983
Industry Commissions	$ 6,956.6	$ 9,992.0
Estimated Retail Commissions	3,130.5	3,697.0
Discounters' Commissions	198.0	331.1
Discounters' Market Share of Retail Commissions	6.3%	9.0%
Industry Gross Revenues	$26,865.3	$34,786.4
Discounters' Gross Revenues	281.5	458.5
Discounters' Market Share of Gross Revenues	1.0%	1.3%

FIRST-HALF 1984

Profitability in the securities industry plummeted in the first-half of 1984. This will be the worst six-month period since October 1, 1977 - March 31, 1978, more than six years ago. During 1Q 1984, pre-tax net income was $511 million and after-tax ROE about 9%. FOCUS Report data for 2Q 1984 are not yet available but we estimate that industry pre-tax income ranged between -$50 million to +$50 million. The last quarterly loss experienced by the industry was 4Q 1978 ($11 million).

Industry profitability was low in 1Q 1984 although higher than the after-tax ROE of 6% in 4Q 1983. Commission revenue and trading profits were aided in the early part of the quarter by interest rates temporarily declining in the aftermath of completion of the surge in Treasury borrowing during December and evidence of slower economic growth. After this initial decline, interest rates rose during the rest of the quarter.

Industry profitability was adversely affected by underwriting revenues in the 1Q 1984 which plunged 32% to $553 million, the lowest level since 2Q 1982. Corporate underwriting volume of $17.6 billion was 8% below the $18.9 billion in the 4Q 1983. Although bond issues were 65% above the volume in the 4Q 1983, the equities markets were devastated with the volume of common stock issues plunging 68% and preferreds decreasing 12%. In addition, tax exempt volume decreased 33%, from $21.7 billion in 4Q 1983 to $14.5 billion in 1Q 1984.

Table 17

Underwriting
(billions of dollars)

	1Q 1984		2Q 1984	
	Dollars	Issues	Dollars	Issues
Corporate:				
Bonds	$14.0	157	$19.8	124
Preferred	1.1	17	1.2	17
Common	2.3	217	3.4	236
	$17.4	394	$24.4	377
Tax-Exempt Bonds	$14.5		$17.5	

Total expenses increased 0.4% in the 1Q 1984 while revenues rose 3%. Interest expense was up nearly 6% to $2.1 billion while so-called fixed expenses (communications, occupancy & equipment, and EDP equipment costs) soared 19% to $862 million. Non-recurring charges which amounted to $93.4 million in 4Q 1983 because of Baldwin United charges dropped to a more normal $1.5 million level in 1Q 1984.

Commission revenues appear to have decreased in 2Q 1984. Combined NYSE, AMEX and NASDAQ average daily volume fell almost 9% to 149 million shares. Moreover, the average price per share traded on the NYSE declined almost 6% to $32.78.

Trading profits probably also fell because of the significant rise in interest rates. For example, the average rate on 20-year U.S. Treasury bonds rose to 13% in 2Q 1984 from 12% in 1Q 1984. In addition, rates rose fairly consistantly until early June when they declined briefly.

Underwriting revenues in 2Q 1984 may have risen slightly from the already depressed 1Q 1984 level (Table 17). Bond market activity gives the illusory appearance of having picked up in 2Q 1984 but this is misleading because of zero coupon bonds. For example, one zero coupon Fannie Mae issue is reported at $6 billion but only $200 million was actually raised. However, there was some improvement in common stock issues and, to a lesser extent, preferred stock issues. In addition, tax exempt volume rose 20% to $17.5 billion.

The 2Q 1984 rise in interest rates also adversely affected industry profitability because of upward pressure on interest expense. Interest expense, which was only $1.3 billion or 16% of total expenses in 2Q 1983, amounted to almost $2.1 billion or 28% of total expenses in 1Q 1984. Both these figures will be significantly higher in 2Q 1984. Thus, both revenues and expenses deteriorated because of rising interest rates resulting in a projected break-even level in 2Q 1984, give or take $50 million in either direction.

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SECURITIES INDUSTRY STATISTICS

VOLUME

	MAY 1984	YEAR-TO-DATE 1984	MAY 1983	YEAR-TO-DATE 1983	% CHG. Y-T-D 1984 - 1983
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	88.2	92.1	93.0	87.8	4.9%
AMEX (MILS.)*	5.9	6.2	12.2	9.2	(32.6)
NASDAQ (MILS.)*	58.0	59.8	71.1	61.6	(2.9)
REGIONAL EXCHANGE (MILS.)*	13.9	14.0	13.0	12.3	13.8
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	64,240	329,594	69,448	313,633	5.1
AMEX (MILS.)	1,666	8,909	3,316	13,338	(33.2)
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	6,362	35,652	8,147	39,630	(10.0)
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	13,875	68,626	15,146	77,528	(11.5)
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	50.4	49.5	44.1	43.6	---
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	10,183	59,197	6,782	36,335	62.9
AMEX OPTIONS	2,412	15,029	3,110	14,880	1.0
COMMODITY	15,043	64,292	8,552	42,248	52.2

* *MONTHLY AVERAGE*

YIELDS
(MONTHLY AVERAGES)

	May 1984	May 1983	Basis Point Change May 84 - May 83
BOND BUYER INDEX (20 BOND)	10.5	9.1	1.4
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	13.28	11.46	1.82
Baa CORPORATE	14.74	13.09	1.65
RATIO Aaa CORPORATES TO Baa CORPORATES	0.90	0.88	0.02
MUNICIPAL BOND YIELD (MOODY'S)	10.49	8.39	2.10

PRICES
(END OF MONTH)

	May 1984	May 1983	% Change May 84 - May 83
DOW JONES INDUSTRIALS	1104.85	1199.98	(7.9)%
STANDARD & POOR'S 500	150.55	162.39	(7.3)
NYSE COMPOSITE	86.71	94.08	(7.8)
AMEX MARKET VALUE INDEX	198.63	230.36	(13.8)
VALUE LINE COMPOSITE	169.26	198.38	(14.7)
NASDAQ COMPOSITE	232.82	308.73	(24.6)

UNDERWRITING
(DOLLARS IN MILLIONS)

	May 1984	Year-to-Date 1984	May 1983	Year-to-Date 1983	% Change May - May	% Change 1984 - 1983
CORPORATE FINANCING (Gross New Issues)						
Total	4,879	30,406	11,271	51,150	(56.7)	(40.6)
Common Stock	1,185	4,540	3,504	16,958	(66.2)	(73.2)
# Of Common Stock Issues	70	364	133	540	(47.4)	(32.6)
Preferred Stock	407	2,025	577	4,962	(29.5)	(59.2)
# Of Preferred Stock Issues	4	30	9	70	(55.6)	(57.1)
Corporate Debt	3,286	23,841	7,190	29,230	(54.3)	(18.4)
# Of Corporate Debt Issues	29	238	77	331	(62.3)	(28.1)
MUNICIPAL FINANCING* (Gross New Issues)						
Total	8,682	42,643	10,684	50,606	(18.7)	(15.7)
Notes	2,310	16,605	2,226	15,077	3.8	10.1
Bonds	6,372	26,038	9,083	36,141	(29.8)	(28.0)
# of Bond Issues	430	1,652	815	2,352	(47.2)	(29.8)
Negotiated Bonds	3,798	17,111	4,799	23,999	(20.9)	(28.7)
Revenue Bonds	3,893	15,472	5,165	24,432	(24.6)	(36.7)

*Preliminary Figures

MUTUAL FUNDS
(DOLLARS IN MILLIONS)

	MAY 1984	Yr.-To-Date 1984	MAY 1983	Yr.-To-Date 1983	% Change Y-T-D 1984-1983
NET SALES*	1106.4	8257.0	1987.6	8571.9	(3.7%)
NET PURCHASE OF COMMON STOCK	171.2	1972.3	1631.9	5794.7	(66.0)
NET PURCHASE OF OTHER SECURITIES	773.2	2550.1	93.8	687.4	271.0
MUTUAL FUND CASH POSITION	12.3	---	10.5	----	-----

*EXCLUDES MONEY MARKET, MUNICIPAL BOND AND OPTION FUNDS

MARGIN DEBT

	MAY 1984	MAY 1983	% Change May 84 - May 83
MARGIN DEBT OUTSTANDING ($MILS)	22,360	16,370	36.6%
NET CHANGE IN MARGIN DEBT ($MILS)	5,990	4,380	---
% OF ACCOUNTS WITH EQUITY UNDER 40%	12	8	---

FINANCIAL DATA FOR NYSE FIRMS DOING A PUBLIC BUSINESS
(MILLIONS OF DOLLARS)

	First Quarter 1984	Yr-to-Date 1984	First Quarter 1983	Yr-to-Date 1983	% Change 1st.Q. 1984 1st.Q. 1983	% Change 1984 - 1983
REVENUE						
SECURITIES COMMISSION INCOME	1,972	1,972	2,112	2,112	(6.6)%	(6.6)%
REALIZED AND UNREALIZED GAIN OR LOSS IN TRADING AND INVESTMENT	1,947	1,947	2,178	2,178	(10.6)	(10.6)
PROFIT OR LOSS FROM UNDERWRITING AND SELLING GROUPS	553	553	843	843	(34.4)	(34.4)
TOTAL REVENUE	7,944	7,944	7,189	7,189	10.5	10.5
TOTAL EXPENSES	6,947	6,947	5,896	5,896	17.8	17.8
NET INCOME BEFORE TAXES	497	497	1,293	1,293	(61.6)	(61.6)
PERCENT OF FIRMS SHOWING LOSS	31.3%	31.3%	10.4	10.4	-	-

RECENT INTERESTING READING AND STATISTICAL MATERIAL

ITEM	DESCRIPTION	SOURCE
SIA's Report on Production and Earnings of RRs in 1983	Annual study presents summary analysis on retail and institutional production, payout, ticket size and earnings as well as trends in these areas over the last ten years. Results are given for the industry as a whole and by firm size category.	Madeleine Ritter SIA $300 non-participating members $1,000 non-members
Securities Industry Yearbook 1984-85	Primary reference source on SIA member firms. Hard-cover, 600-page edition contains 5 sections: Firm rankings by capital, Information on publicly-traded firms, Detailed firm data, Geographic listing, and Industry & Market statistics.	SIA Yearbook Dept. $45 members; $70 non-members (+ sales tax for NY purchases)
"The Euromoney Five Hundred"	Annual ranking of the world's 500 largest banks by equity. Statistical features include: top 100 by ROE, assets and net income; fastest growing and slowest growing; and leading banks by country.	Euromoney 6/84
"Wall Street puts its own money on the line"	Review of development of merchant banking activities on Wall Street. Rationale for development: with margins in traditional lines of business under increasing competitive pressure, investment bankers see merchant banking as a way of enhancing profitability as well as nourishing and protecting capital.	Institutional Investor 6/84
Mergerstat Review - 1983	A 150-page statistical reference source on merger activity in 1983, with certain historical observations. Five major sections include data on: dollar value paid, medium payment, acquisition leaders, divestitures, and foreign buyers and sellers.	W.T. Grimm & Co. 135 South LaSalle Street Chicago, Ill. 60603

ITEM	DESCRIPTION	SOURCE
Economic Choices 1984	Authors of this book present a detailed plan for reducing the deficit and increasing future flexibility in domestic spending, improving the effectiveness of defense expenditures, and reforming the federal tax system. In addition, new directions in industrial and trade policy, government promotion of R&D, and policies to aide poor and dislocated workers are suggested.	The Brookings Institute 1775 Massachusetts Ave., N.W. Washington, D.C. 20036
The Deficit Dilemma--Budget Policy in the Reagan Era	Authors Mills and Palmer in five chapters review the changing federal budget deficit under President Reagan from the initial budget plan to the economic-political dilemma now posed by the size of the deficit. Authors conclude that the disparity between projected federal revenue and outlays is so great as to require action on 3 major fronts: tax increases, a scaleback of the defense buildup, and restraint on domestic spending.	The Urban Institute 2100 M Street, N.W. Washington, D.C. 20037
"Upheaval in Life Insurance"	The inflation and high interest rates of the late 1970s have forced the insurance industry to rethink its basic product. To compete, many insurance companies are also adding mutual funds, limited partnerships and other securities-based investment packages. Article reviews pros and cons of new strategies for insurance industry.	Business Week 6/25/84
"Pound of Flesh, Ounce of Balm"	Somewhat humorous capsule summary of the 1984 Tax Bill, focusing on implications for investment.	Barron's 7/2/84